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Durham University
Durham, United Kingdom

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January 2012

**“Sukuk Issuance in Saudi Arabia:
Recent Trends and Positive Expectations”**

Supervised by

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and Dr Mehmet Asutay, Ph.D*

Abstract

The objective of this research is to assess the potential for corporate sukuk in Saudi Arabia by examining issuance so far and seeking opinions from market makers as to how this type of financing can be taken forward. The research considers the appropriateness of Sukuk as long-term Shari'a-compliant financing instruments. One objective is to investigate how Sukuk issuers can tap liquid funds and harness them to contribute to the funding of infrastructure and industrial projects.

The thesis investigates the recent Sukuk issuance trends and positive expectations relating to Sukuk issuance in Saudi Arabia, and concludes that the outlook for Sukuk origination in the Kingdom is positive. As the largest oil exporter in the world, Saudi Arabia has a substantial capital market. It has been benefiting from steady high oil income during the last few years and this, in turn, has increased the Saudi market liquidity to unprecedented volumes.

An important part of the study is the analysis of corporate Sukuk issuances in the Kingdom between 2004 and 2010. Detailed case studies are presented illustrating the range of Sukuk structures used. Furthermore, the research also involves semi-structured interviews and focus group discussions with key individuals from Sukuk issuing entities in Saudi Arabia using a homogenized survey mechanism.

The semi-structured interviews and focus group discussions sought to discover the Sukuk issuers' insights into the prime barriers to business growth, the comparative significance of the numerous constraints to increase corporate Sukuk issuance, and the effects of Saudi Arabia's investment environment on its competitiveness.

The major implication of the findings is that Sukuk, as securitized liquid financing instruments due to their tradability, are useful long-term financing solutions for companies in Saudi Arabia. Sukuk are becoming important financing instruments complementing the dominant bank loans and IPOs. The research also highlights the long-term outlook and the probable future challenges facing the Sukuk market in the Kingdom.

Acknowledgements

This thesis explores the potential for corporate Sukuk in Saudi Arabia. In collating my research I have worked with academics, industry professionals and industry experts. Therefore, I am grateful for their invaluable contribution which has added value to my thesis.

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Chapter One

Research Rational and Motivation

Introduction

Sukuk, plural of the word Sakk (Arabic: صكوك, plural of صك Sakk, "legal instrument, deed, check") is the Arabic name for an Islamic investment trust certificate, which has increasingly gained popularity in the financial markets in recent years. During the flourishing period of Islam in the 13th century, Sakk which is believed to be the source root of the European "Cheque", was referred to any certificate representing a contract or conveyance of financial rights, obligations or money transactions that is Shari'a-compliant for a thriving trade activities (Nathif & Thomas, 2004).

The word Sukuk has been used erroneously as a singular noun, and Sukuks as plural by finance professionals. The accurate practice would be to treat the word Sukuk as a plural word. The contemporary Sukuk concept is based on asset monetisation or securitisation which is the course of issuance of Sukuk (Taskeek) by converting the future cash flow of an asset into present cash flow. "*Lisan Al Arab*" illustrates the fact that the original meaning of Sakk in the Arabic literature denoted "staking a seal on a document." (Ibn Al Ifriqi, 1985)

In this dissertation I have embraced the established transliteration for Arabic expressions including the word Sukuk which is recognized in the global financial markets. Using Roman characters to promote Arabic phrases have been helpful in promoting many Arabic aspects including values, culture and religion.

Sukuk have grown rapidly in prominence over the last decade as demand for Islamic financial products and services have similarly increased and more financial institutions enter the market. The Sukuk market is projected to have strong long-term growth prospects.

Sukuk are facing an unexpected boom in demand driven by new Shariah-compliant investment structures engineered by both Islamic and conventional capital markets. The pioneering Sukuk are turning out to be the first investment choice for investors, as they are securitized liquid instruments due to their tradability. Sukuk are ideal Shariah-compliant instruments because they offer local investors risk diversification options for their portfolios. In addition, originators prefer Sukuk because they can borrow for the long-term with favourable terms and at lower costs even if there are slightly higher upfront costs in structuring, arranging and legal services.

Increasingly more structured Sukuk solutions are being offered with better risk/return structures because they are gaining vast appeal for diversification purposes among investors. With fierce competition among Islamic and conventional banks to structure Islamic financing products, the lucrative local Saudi Sukuk market is growing fast and shows enormous potential.

This potential is recognized by international banks such as HSBC Amanah, Deutsche Bank, Citigroup, Standard Chartered Bank, BNP Paribas, Societe Generale et al, who are competing to establish, structure and issue Shariah-compliant financial instruments, in particular Sukuk. Such attempts by these banking majors are expected to gain momentum in the underdeveloped Sukuk market.

Sukuk could fill the gap caused by the lack of long-term conventional financing instruments such as Treasury bonds and bills, which are prohibited under Shariah because they generate their return from interest (usury). Interest-based bonds are presumed to be exploitative in Islamic finance and are therefore proscribed. The spectacular growth in issuance and demand for Sukuk is underpinned by the fact that their core investment mechanism offers a share in the proceeds from a business venture rather than through interest payments.

Sukuk contracts are distinctive to the extent that their ownership privileges and financial obligations are based on diverse Shariah-compliant contracts such as Mudaraba (trust

financing), Murabaha (cost-plus financing), Istisna (forward sale used in construction finance), Ijara (leasing), Musharaka (equity participation), and Salam (forward sale for commodities). Most such flexible financing contracts can be securitized and turned into the long-term tradable instruments under the concept of Sukuk.

However, there are tradable Sukuk and non-tradable Sukuk. Tradable Sukuk are representing tangible assets or proportionate ownership of a business or investment portfolio. For example, Sukuk of Ijara, Istisna, Mudaraba or Musharaka are tradable. Non-tradable Sukuk represent receivables of cash or goods. For example, Sukuk of Salam or Murabaha are non-tradable Sukuk (AAIOFI, 2003).

My dissertation concludes that the prospects for Sukuk origination in the Kingdom are positive and substantial. As the biggest oil exporter in the world, Saudi Arabia has a huge capital market. It has been benefiting from steady high oil proceeds at record levels for the last few years and this, in turn, has fuelled Saudi market liquidity to unprecedented volumes.

Saudi Arabia is projected to maintain such stable growth for the next few years. With increasing demand for Shariah-compliant financial solutions within Saudi Arabia, these factors will drive the Sukuk market to thrive in the flourishing Saudi public and private sectors. Sukuk are increasingly playing a leading economic role in the Kingdom's financial market as a form of long-term financing. Already signs of Sukuk growth are surfacing in Saudi Arabia and the Gulf Cooperation Council (GCC) region with the few local, and significantly more numerous regional issuances being heavily oversubscribed, largely by Saudi investors.

Sukuk could be a main source of capital flows and a major provider of debt financing for corporates in Saudi Arabia. In fact, there are signs that Sukuk are already accounting for a considerable portion of this debt financing.

Sukuk are also leading debt financing instruments for the economic and industrialization boom in Saudi Arabia, because they can be securitized with underlying assets, and generate liquidity due to their tradability, flexibility in structure, and rateability. However, in Saudi Arabia there is currently no established secondary market for Sukuk trading. Although Tadawul, the Saudi Stock Exchange company established in March 2007 as a joint stock company to regulate the market for trading in the capital market under the sole regulation and monitoring of the Capital Market Authority (CMA) (Tadawul 2011), launched a Sukuk and bond trading platform in 2009, the uptake has been minimal to date. Equity or government financing cannot meet all of the rising demand for long-term financing for public and private businesses (Parker 2007).

The main principle of Islamic commercial jurisprudence is that all commercial transactions are *mubah* or lawful except for a few non-negotiable and entrenched restrictions such as the prohibition of *riba* (usury or interest), *maisir* (gambling), *gharar* (deception through non-disclosure of relevant information), dealing in unlawful business activities and goods and services such as alcohol, pork production and distribution, casinos and conventional finance which encourages interest-based banking, short sales or/and speculative transactions.

These faith-based injunctions are to assure balanced socio-economic justice and equality of business opportunities, which constitute the main differences between capitalism and Islamic economics. Socio-economic considerations are a critical pillar in Islamic financing, with the promise of divine and earthly rewards for a system which balances economic, social, ethical and spiritual dimensions.

Hence, financial return is not the only factor considered when dealing in Shariah-compliant commercial or financial transactions. Spiritual and after-life rewards are also important considerations, and consciousness of divine justice is required to be the basis of all Islamic financial transactions.

However, in order for Sukuk to succeed, they have to compete against their conventional and other Islamic financing counterparts and to be attractive from an economic perspective.

One of the most interesting areas for research in the field of Islamic economics is Islamic finance. The key feature of Islamic financing is that it pays no interest and is asset-backed financing, as money has no intrinsic value and is merely a medium of exchange. Islamic financing mechanisms take into consideration the best interests of all the stakeholders and related economic considerations.

In Islam, money must be invested, not accumulated avariciously, and such investments must be for the benefit of the community and in mubah or lawfully profitable tools. Moreover, what is unique about the genuine Islamic commercial spirit is that it encourages profit making and risk containment in a profit/loss sharing mechanism, and that is the ultimate divine justice by Allah (God).

Research Objectives

The objectives of this research focus on supporting the proposition of positive trends in Sukuk issuance in Saudi Arabia by investigating the potential for their success. The research objectives are to establish the suitability of Sukuk as long-term Shariah-compliant financing instruments capable of financing mega-projects such as hospitals, schools, roads, railways, commercial cities and other public and infrastructure facilities in the Kingdom.

There is a necessity in Saudi Arabia for long-term financing instruments such as Sukuk. Saudi Arabian needs for financing have been evolving very rapidly particularly after the Kingdom joined the World Trade Organization (WTO) and liberalised many vital sectors for foreign investments, promoting mega-investment opportunities for strategic investment, and improving the sovereign credit environment.

The market in Saudi Arabia is an attractive niche market for risk-return investment opportunities and long-term financing instruments such as Sukuk. Even though there is considerable potential for Sukuk growth in Saudi Arabia, certain measures must be taken by regulatory bodies to facilitate Sukuk origination for maximum benefit. The nascent debt market is looking forward to promoting Sukuk issuance in Saudi Arabia as these are the most eligible instruments to supply the gap in long-term financing and asset securitization instruments.

Sukuk could channel the abundant surplus liquidity in Saudi Arabia towards the creation of strategic infrastructure projects across the country, particularly in the underdeveloped remote rural areas. A core research objective of this thesis is to identify the most effective means to promote Sukuk as a source of financing in Saudi Arabia, especially at a time when the Kingdom must capitalize on the emerging role and opportunities of Sukuk origination.

This study hopes to show that Sukuk could leverage the current rapid economic growth in the Kingdom. The Saudi economy is showing unprecedented diversification and Sukuk could be one of the growth drivers for development in Saudi Arabia. The features of Sukuk as long-term securitized liquid financing instruments with great potential for public acceptance and investment, which it is suggested, will be the major factor for their growth.

Moreover, my research will show that Sukuk would be able to fund the current Saudi Arabian construction boom if oil prices eventually start on a downward cycle. An additional aim of my research is to identify the means to promote a more profound understanding and awareness of Sukuk, and the means to increase the demand for more issuances and thus to identify the competitive advantage of Sukuk in Saudi Arabia.

Hence, the research objectives are summarized below:

- a) To examine how Islamic financing instruments and the Sukuk market in Saudi Arabia have developed and progressed.

- b) To demonstrate that the availability of developed and innovative Sukuk structures could increase the depth and volume of Sukuk issuance and create an active Sukuk market in Saudi Arabia.
- c) To show that establishing a clear and viable legal and regulatory framework infrastructure would enhance the Sukuk issuance.
- d) To identify the ways in which Saudi Arabia could unlock the Sukuk market potential.

Research Questions

The following questions will be addressed:

- i) What are the recent trends and expectations for corporate Sukuk issuance in Saudi Arabia?
- ii) What are the barriers to corporate Sukuk origination in Saudi Arabia?
- iii) What are the reasons why the financing offered by the Saudi banking system cannot be a substitute for financial instruments such as Sukuk?
- iv) Why have Saudi corporate entities largely tapped only into the equity market?
- v) How could a greater choice of corporate Sukuk structures increase issuance?
- vi) What are the barriers for an active secondary Sukuk market in Saudi Arabia?
- vii) How could the Capital Markets Authority (CMA) (the Securities Regulator in Saudi Arabia) develop the commercial arbitration system in Saudi Arabia?
- viii) In what ways would the establishment of a clear and viable local unified regulatory, accounting and auditing framework infrastructure enhance Sukuk issuance in Saudi Arabia?

Research Rationale and Motivation

Based on the Quranic verse: *"...they say 'Trade is like usury', but God hath permitted trade and forbidden usury"*, the basic rationale of Islamic financing is the prohibition of "Riba", derived from *yarbou*, literal meaning to "grow", and which is a transliteration of an Arabic word and not limited to usury and interest.

Nonetheless, there are different types of *riba*. The most known are two types: *riba al-fadl* and *riba al-nasiha*. *Riba Al-fadl* or usury of surplus is an exchange of unequal qualities or quantities of the same commodities simultaneously. This entails employing what seems to be a sale or exchange, but in reality it is a loan with interest.

The second type is *riba al-nasiha* which involves the non-simultaneous exchange of equal qualities and quantities of the same commodity and no surplus is involved but only difference in the timing of exchange (El-Diwany, 2003). There is no risk involved in this kind of *riba*. All these different kinds of *riba* were prevalent in Arabia before the dawn of Islam. The Prophet Mohammed (pbuh) said: “*Gold for Gold, Silver for Silver, Wheat for Wheat, barley for barley, dates for dates, salt for salt – like for like, hand for hand. Whoever pays more to takes more, indulges in riba. The taker and giver are alike (in guilt)*”(Khan, via Sahih Al-Bukhari, 1995).

Riba has been prohibited in Islam for many reasons including fear of exploitation of the needy leading to social injustice and economic inefficiency resulting in discouraging tangible growth and promoting social and economic inequalities and consequently inciting social instability. The recent 2008-9 global financial crisis was partly caused by diverse financial derivatives widespread in the global markets that are against the basic tenets of Islamic financial instruments including Sukuk in that they are not asset backed or underpinned with cash flow generating assets. As a result, this has spurred financial speculation for short-term profits in the global financial markets.

"*Gharar*" is a transliteration of an Arabic word meaning ambiguity and uncertainty, which is speculation through deception. *Gharar* is a complex concept that covers a wide range of uncertainties or contingencies in a contract. This includes details related to the sale item such as time or place of delivery or price which are unidentified or vague, thus leading to a risky sale. *Gharar* in a sale could potentially result in excessive risk due to uncertainty. In Islamic finance, money should act as a store of value for tangible trade or business, and investors should share a profit or loss in the transaction or business. Hence, there are stringent rules in Islamic finance against transactions that are doubtful causing

fraud, risk or deceit against any stakeholder that might lead to a loss. That's why all Islamic finance contracts must be built on transparency and full disclosure of all necessary information in order that one party does not have an advantage over the other party (Staff Writer, Financial Islam, 2011).

Therefore, debt based Sukuk can not be traded other than at par value as they represent riba. The Islamic debt financing instrument, Sukuk, are urgently needed in Saudi Arabia because not everyone who owns money has trading skills or the capacity to do business, and not everyone who has skills in trading possesses money or resources (Ibn Qudamah).

For business in Saudi Arabia, creating goods and services requires Shariah-compliant financing instruments such as Sukuk to produce and generate profit to be distributed between the financier and the entrepreneur according to an agreed formula. Such a formula should take into consideration equal rights for both parties, so that one does not exploit the other. In addition, Islamic financial tools should be competitive with conventional counterparts such as long-term securitized liquid financing instruments and other tradables.

A major obstacle for Islamic capital market growth in Saudi Arabia is the lack of proper long-term financing and investment tools for private and public sector expansion. For this reason, Islamic financing instruments such as Sukuk would be the best means for increasing the efficiency and effectiveness of financing for Saudi Arabian corporates and would serve to meet their funding gap. Recent signs of a resurgence of Islamic financing in Saudi Arabia are due to the enormous demand from Saudi investors. Demand is coming from every social and economic spectrum, because Sukuk's Shariah compliance is allied with the competitive returns generated by such products (Watheeqa, 2010).

The rationale of this research is to add value to the Sukuk market in Saudi Arabia by demonstrating the need for and the efficacy of corporate Sukuk origination in the Kingdom. However, corporate Sukuk in Saudi Arabia will prosper only if they are able to compete against the various traditional financing instruments.

Hence, developing and innovating long-term types of Sukuk with feasible economic features, such as securitization and liquidity, are essential for them to flourish. With innovative structuring, competitive rules and regulations, and the appropriate technical infrastructure, Sukuk could be a major driving force in the economic progress and development of the Kingdom.

The critical and distinctive feature of Sukuk is that they must involve the funding of trade in, or the production of, real assets which minimizes risk and boosts tangible development.

Moreover, the Saudi capital and real estate markets lack the necessary depth and liquidity due to the limited range of financial instruments available, compared to the equity and the real estate markets. This is particularly so for Shariah-compliant products. That is why there has been a comparatively sizable exposure to the equity and real estate markets particularly in the Saudi capital markets, which caused serious damage with the recent equity market collapse (AlJaziracapital 2010).

Sukuk efficiency and effectiveness in monetizing and utilizing tangible and intangible assets, turned into tradable instruments, would generate an attractive risk/return balance for more productive projects, and minimize sovereign and corporate credit risk exposure. Sukuk would add value and diversification by minimizing the vulnerability of Saudi financial institutions to shocks in equity and real estate market. Currently the most widely used collateral demanded by Saudi financial institutions are real estate and equity portfolios (Azzam, 2006). Sukuk are flexible instruments that can monetize almost all potentially legal productive projects to become eligible for financing.

Thus, it is critical for my research to demonstrate the structures of Sukuk contracts according to both the principles of Fiqh Al-Muamalat (Islamic Law relating to Financial Transactions) and on the basis modern economic and capital market thinking. The crucial and synergistic combination of these two factors have bolstered and leveraged the

position of Sukuk in the Saudi Arabian capital market. Innovation has made Sukuk more attractive as they are securitized liquid financing instruments due to their tradability. Consequently, a major objective of this research is to demonstrate and empirically support the efficacy of Sukuk origination and market development in Saudi Arabia by exploring the prospects for their success (Hassan and Mahlkecht, 2011).

With Sukuk gaining a considerable amount of attention in the local capital market, there are several reasons why Sukuk are becoming attractive financing instruments including:

- i) Sukuk can offer long-term financing solutions with favourable terms.
- ii) Sukuk are securitized financing instruments with tangible and intangible assets.
- iii) Sukuk are liquid instruments due to their tradability.
- iv) Sukuk are Shariah-compliant financing instruments preferred over conventional bonds by local investors.
- v) Sukuk can offer an alternative mode of financing from traditional bank financing and the volatile equity market.
- vi) The global appeal and acceptance of Sukuk is drawing international financial institutions to add value to this niche industry by structuring innovative Sukuk and consequently adding value to the Saudi capital market (Bochari, 2007).
- vii) The huge wealth of Gulf countries, especially Saudi Arabia, due to record oil prices is producing a substantial demand for investment opportunities in instruments such as Sukuk.
- viii) Saudi sovereign and corporate entities are looking to diversify their financing options to minimize risk and satisfy their devout Muslim shareholders.

Research Methods

Research methods are defined as the different techniques that prove useful while executing the methods of research. The qualitative research methods of this research will explain the various procedures conducted by performing several techniques to examine how Islamic financing instruments such as Sukuk in Saudi Arabia have developed and

progressed. Qualitative research has the aptitude to present documentary descriptions of how the public understand a specified research subject by supplying the needed information about a particular relevant issue to conceptualize their beliefs, deeds, and sentiments. Qualitative research is widely implemented due to its effectiveness in revealing indistinct aspects like socio-economic conditions, public customs and religious norms related to this research. The conclusions from qualitative data can be broadened to related professionals who share comparable characteristics for more accurate outcome (Denzin and Lincoln, 2005).

The purpose is to demonstrate that the availability of developed and innovative Sukuk structures that could increase the depth and volume of Sukuk issuance and create an active Sukuk market in Saudi Arabia, show that establishing a clear and viable legal and regulatory framework infrastructure would enhance the Sukuk issuance, and identify the ways in which Saudi Arabia could unlock the Sukuk market potential.

Hence, my research methods will carry out systematic analyses focusing mainly on reviewing and analyzing the local corporate Sukuk issuances within the Kingdom between 2004 and 2010. The research methods were developed during my research, literature review, collation techniques and the study of actual Sukuk structures and their implementation. My study focuses on the local Sukuk market within the boundaries, regulations and laws of the Kingdom of Saudi Arabia.

The research methods used is qualitative, because I am focusing on examining the promising prospects for corporate Sukuk issuance in Saudi Arabia. These samples consist of semi-structured interviews and focus group discussions of firms engaged in corporate Sukuk from various industries. The research will be evaluating business institutions which have a common interest in issuing Sukuk. These include obtaining all necessary licenses and permits and completing any required announcements, substantiations, and/or documentations for an issuance with relevant authorities such as the Capital Market Authority (CMA).

After a study of Sukuk laws, regulations and publicly available information on business entry, an itemized directory of the system was developed, along with the time and cost of fulfilling each item within regular circumstances.

Data has been gathered on the sequence in which procedures were finalized and whether these procedures were achieved concurrently. It is believed that any necessary information is accessible and that all stakeholders involved are functioning appropriately and efficiently.

To illustrate and demonstrate the objectives of any research requires the development and use of appropriate research methods. The potential for corporate Sukuk in the Saudi Arabian debt market was analyzed after gaining the perspective of corporate directors for corporate Sukuk issuers and potential issuers from different mega-industries like the petrochemical, manufacturing, real estate development and services industries.

There are three main aspects to this research method: i) sampling which consists of case studies, semi-structured interviews and focus group discussions, ii) data collection and collation, iii) and data analysis.

Sampling has become a prerequisite for developing an appropriate description for most dissertations. Thus, accomplishing my task in my research would require taking into consideration the investigation and examination of all corporate Sukuk issues – both theoretical and applied. Hence, in my research I have targeted the executives of Saudi firms, market regulators, institutional and individual investors and getting their feedback concerning the prospects, demand and challenges for corporate Sukuk in Saudi Arabia (Jankowicz, 1991).

Hence, sampling experimentation involves a specific segmentation of business called "units of analysis" that is designed in this case to collect and interpret the structure and dynamic of Sukuk. This is a thorough process designed for selecting current and possible

Sukuk issuers and investors in comparison to global Sukuk stakeholders. This would allow my research to deliver a more precise outcome and analysis for a clearer scenario of the progress of Sukuk (Kenny, 2010).

The rationale behind an organized sampling is:

- i) Sukuk data will be collected from an interest group comprised of Sukuk issuers, potential Sukuk issuers, and Sukuk arrangers.
- ii) It is a cost and time-efficient methods for accomplishing results.
- iii) It provides a wider description of the status quo.

Sampling procedures can illustrate my research with examples of general issues based on the answers to questions such as:

- a) What are the main characteristics and parameters of Sukuk?
- b) Why are Sukuk gaining an increasing momentum in the local market?
- c) How does one unlock the latent potential of such securitized liquid financing instruments?

The research techniques have involved a random selection of Sukuk from different investment houses based on Sukuk issuances limited to the last five years. My purpose is to find the common denominators and motives for the origination of Sukuk by the above issuers.

Moreover, I also randomly selected samples from the other end, the institutional and individual investors and the strategies underlying their Sukuk investment. I will be classifying the corporate Sukuk according to their industries and using the sequence date of issue. My random sampling procedure emphasizes proportionate representation to support the various conclusions.

Research Content and Structure

The thesis is divided into Ten Chapters. The structure was evolved and derived from the research strategy. The research content and composition of the thesis is developed as follows: Chapter One provides an introduction to the research which consists of a dialogue on the topic. The first section of the chapter provides a descriptive overview of the research, describing the features of corporate Sukuk issuance and their encouraging potential in Saudi Arabia, with a statement of the clearly defined objectives of the research. The second section of the Chapter introduces the basic questions. The third section highlights the research rationale and motivation for conducting my research. The fourth section of the Chapter is to establish the research methods and content.

Chapter Two is an elaboration on the Sukuk definition by discussing a range of characteristics employed in the literature for understanding the concept of Sukuk. The range of characteristics includes the comparison of Sukuk with conventional debt instruments, structure, pricing, tenor, assets and rating. The rationale for this chapter is to explore relevant views of the market to give a wider perspective on the subject.

Chapter Three concentrates on the existing financial markets in Saudi Arabia. The Chapter begins with a general overview and analysis of the different market segments. The research evaluates and examines the role of the different financial market segments in Saudi Arabia. The purpose of the study is to underline the contribution of the financial markets and the importance of developing securitized liquid financing instruments such as Sukuk in Saudi Arabia.

Chapter Four provides an in-depth description of the corporate finance industry in Saudi Arabia. The first section underlines and assesses the types of bank loans, informal finance, equity finance and syndicated finance for mega-projects being provided to corporate entities in the Saudi market. The purpose of this Chapter is to stress the need for an alternative mode of financing like corporate Sukuk in the corporate finance industry in Saudi Arabia.

Chapter Five focuses on corporate Sukuk structures issued by Saudi Arabian companies. This chapter describes the most suitable Shariah-compliant Sukuk structure in a rapidly evolving Sukuk market. Hence, it is important to identify the suitable underlying assets to be securitized via an independent SPV (Special Purpose Vehicle).

Chapter Six describes my research methods and the empirical work. This chapter explains the connectivity between the research questions, objectives and methods by means of data collection analysis and interpretation. My research uses a qualitative research methods and empirical work for the purposes of exploring and evaluating the prospects for corporate Sukuk in Saudi Arabia.

Chapter Seven focuses on analyzing particular corporate Sukuk case studies in the debt market in Saudi Arabia. Each case study is carefully analyzed to provide information and an understanding of the rationale for Sukuk origination. The analysis will include the issuance performance evaluation, structure and rating. Diagrams are used to illustrate the Sukuk structure, financial transfers and the rights and obligations of the Sukuk issuers and investors.

Chapter Eight comprises the semi-structured interviews with relevant Sukuk investors and bankers and appraising the outcome of the exercise. This is to draw out, explore, and analyze the interviewees' feedback on the various issues relating to Sukuk structures.

The interviewees were asked about the Sukuk pricing, structure and the underlying assets for investors, the issue of default, and the risk related to the underlying assets, purchase undertaking, currency preference, the contribution of Sukuk to the corporate finance industry in Saudi Arabia, and the types of Sukuk suited to the requirements of Saudi companies.

Chapter Nine concerns the corporate perspective on Sukuk issuance: findings from a focus group comprising Saudi finance directors. The first section of the chapter evaluates the prospects for corporate Sukuk in different industries in Saudi Arabia. These industries

include the telecom, construction, transport, insurance, and New Economic cities infrastructure. The second section of this Chapter features the discussions with a focus group comprising Saudi finance directors on the prospects and challenges of corporate Sukuk in the Kingdom.

Chapter Ten presents the conclusion which emphasizes that Sukuk, as a securitized liquid financing instrument due to their tradability, are the best long-term financing solutions for companies in Saudi Arabia. I also highlight the long-term outlook and the challenges facing the Sukuk market in the Kingdom.

Chapter Two

Evolution of Sukuk Structure and Mechanism

Introduction

The recent rapid expansion of the Islamic financial market has resulted in the implementation of Shariah-compliant sovereign and corporate Islamic structured financial instruments known as Sukuk. The development and introduction of Sukuk as an investment class has increased the category of financing instruments that can be used to produce efficient securitized liquid instruments due to their tradability.

Sukuk are also becoming a promising option as a financing instrument that is compatible with portfolio theory and financial planning. Financial engineers are coming up with several Sukuk structures for corporates to raise financing from the Islamic financial markets for balance sheet purposes, expansion capital, working capital and debt re-financing; and for asset managers to invest in as part of their portfolio diversification strategies (Oakley, 2011).

While the main types of Sukuk structures are theoretically straightforward, they may become complicated in practice compared to bonds, as some financial institutions combine characteristics of two or more types of tools to form hybrid instruments. Nonetheless, issuers are promoting these Sukuk with the same features as conventional bonds so as to facilitate the progress of their recognition in both Islamic and conventional financial markets. When comparing Sukuk to bonds, the crucial concept underpinning the Sukuk is that Sukuk certificate holders share the profit/loss revenues of an enterprise. However, bonds represent pure debt obligations; Sukuk holders may be affected by asset related expenses; bond holders are not affected by asset related expenses; Sukuk prices depend on the market value of the underlying asset; bonds depend solely on the creditworthiness of the issuer; selling Sukuk is principally the sale of a share of an asset; selling bonds is principally the sale of debt. However, Sukuk and bonds share some similarities such as ratability, credit enhancement and versatility.

Miller, Challoner, and Atta (2007) maintain that the Sukuk structure is similar to conventional bonds. The main difference is in the returns which in Sukuk are generated from an underlying asset and in bonds from the obligation to pay interest. Also, Wilson (2008) explains that investors are more cautious to provide Sukuk duplicate to other conventional securities because they seek to facilitate investor's risk assessment of these new asset class. Consequently, Sukuk reflect conventional securities in terms of pricing risk characteristics.

The general lack of awareness of Sukuk structures, particularly in the large and medium-sized enterprises, in addition to the absence of a clear legal and regulatory framework, are the primary reasons why Sukuk took more time to develop in Saudi Arabia compared to Malaysia and other Gulf Cooperation Council (GCC) States. In fact, the Sukuk Law in the Kingdom was developed in tandem with the structuring of the first Sukuk in the Saudi market, the SR3 billion 5-year public Sukuk offering by Saudi Basic Industries Corporation (SABIC) in 2006 (Islamic Finance, 2006).

The paradigm of Sukuk security originated from the conventional securitization mechanism in which a special purpose vehicle (SPV) is established to acquire assets and to issue financial rights on the assets. The rights of these financial assets represent a proportionate beneficial ownership to the Sukuk holders.

Islamic project finance; structured finance; capital market products such as Sukuk; private equity; construction finance (Istisna); and equipment leasing (Ijarah) are appropriate to these sectors, particularly from an investor risk-reward profile perspective (Keenan, 2010).

Sukuk are a securitized and therefore liquid asset class, which makes them attractive for issuers because they can obtain long-term financing with favourable terms. However, with the rapid growth of the Islamic finance industry in general, global banks, like their regional and national counterparts, are increasingly focusing on and investing in Sukuk as these are highly adaptable to global market dynamics due to their asset-backed structure.

Furthermore, there is an urgent need to adopt and implement the legal framework to facilitate Sukuk origination; trust laws; and laws relating to the establishment of SPVs which are often used in Sukuk structures. A solid legal framework and a tried and tested court procedure and process to ensure recourse in law in the case of a default, also gives legal certainty and comfort to both issuers and Sukuk certificate holders (Elmalki and Stone, 2009).

The legal risks, lack of enforceability and the initial higher costs of Sukuk structuring are obfuscating efforts to foster a faster evolution of Sukuk and an Islamic capital market in Saudi Arabia. However, the 2003 Capital Markets law reform program in the Saudi Arabia has developed a wider appreciation and development of a Sukuk culture amongst Saudi lawmakers, financial and capital market regulators (Al Malki, 2008).

Sukuk Structure

According to the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) (2003), Sukuk are defined as certificates of ownership of a pool of underlying assets, in which the certificates are of equal value, issued with the aim of using the mobilised funds for establishing a new project, developing an existing project, or financing a business activity as per their respective shares. Returns to investors or Sukuk-holders represent rights to receive periodic payments from a trade transaction, ownership or a particular asset, or a business venture. This in contrast to conventional bond holders where returns represent the right to receive indebtedness for borrowed monies.

Sukuk thus represents ownership of an asset or its usufruct, where the claim embodied in Sukuk is not simply a claim to cash flow but to ownership of the asset or its use over the given period of time or tenor of the issuance. This differentiates Sukuk from conventional bonds as the latter involves interest bearing securities, whereas Sukuk are essentially investment certificates consisting of ownership claims to a pool of tangible and/or intangible assets.

Sukuk are financial papers representing financial obligations originating from trade and other commercial activities. Through a securitization process, Sukuk are the ownership of the underlying assets transferrable to a large number of investors through certificates representing proportionate value of the relevant assets. As described by Clifford Chance (2006), Sukuk investment principles prohibit the charging, or paying of interest, for the reason that interest is based on charging money on money.

The Shariah classifies money to be a means of exchange and a measuring mean for value and not assets, hence, the Shariah proscribes accepting proceeds from money, like the trading/selling of debts, receivables, conventional loans and credit card interest (Thomas & Adams, Islamic Bonds 2004).

The Shariah rationale is to promote the production of tangible assets for real value for the economy and the community. The rich do not have the right to take advantage of the need for money for the poor, because this is considered socially repressive and regressive and inculcates a sense of injustice and thus pre-empts social cohesion.

Financial assets that comply with Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets. In addition there are restrictions which mean that securitized assets are not to be over-leveraged during the course of asset backing.

Sukuk instruments can thus help to unlock the unlimited possibilities, especially for financing a whole range of financial and economic activities and originated by a bevy of issuers ranging from sovereign, quasi-sovereign, multilateral, corporate and even social ones.

The evolution of the Islamic capital market in the last decade has elevated the importance of Sukuk compared with other traditional fixed income instruments. The publishing of the Shari'a Standard on 'Investment Sukuk' in May 2003 by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) has boosted the regulatory and legal basis for such Sukuk Issuance. However, the most recent Sukuk issuances were

largely dominated by debt structures and not equity financing, hence, these Sukuk do not represent a genuine ownership of the underlying assets.

Literature Review:

The current literature on Sukuk has evolved and proliferated over the last decade in tandem with the rapid expansion of the global Sukuk market and the Islamic capital market.

However, the literature concentrates largely on descriptive analysis on Sukuk structures, issuances and Shariah issues as opposed to empirical analysis relating to regulation; legislation regimes; performance; benchmarking and pricing; specific Shariah compliance issues relating to purchase undertaking and guarantees of principal, rating; use of proceeds; and demand dynamics, et al.

Sukuk literature can be divided into four basic categories. The quality and depth of analysis varies from author to author and from institution to institution. The information and analysis of Sukuk also differs from region to region because of differences in the level of development of regulatory and legal regimes and Shariah governance frameworks. This is especially so between Malaysia and south east Asia on the one hand and the GCC countries and south Asia on the other hand.

The literature, it must also be acknowledged, is also constrained by the lack of academic research in general on the subject of Sukuk, say compared with the cornucopia of literature on conventional bonds; the under-developed research and development budgets in the Islamic finance industry; the lack of academic institutions teaching dedicated courses on Islamic banking and financial theory and market developments; the lack of a global standard and accreditation for such academic courses; and the tendency of authors to publish descriptive papers and books on the subject matter for political, institutional or other reasons.

The **first category** in my literature review is the theoretical work done by various academics, analysts and experts. This category explores inter alia the nature of Sukuk and their viability as an alternative source of or instrument for fund raising to conventional bonds in global markets. This category is covered by authors such as Jaffer (2011) who assessed how innovative Sukuk can benefit the global economy; Daruwalla and Siddiqui (2010) who have highlighted the intrinsic value of Sukuk and their application predominantly in the sovereign Sukuk market; and the comprehensive book by Nathif and Thomas (2004) on the Sukuk market including how to identify eligible assets, set up SPVs (Special Purpose Vehicles), credit enhancement, and the challenges and opportunities in the Sukuk market.

The **second category** is the numerous papers, statements and publications published by regulators, standard-setting bodies and industry professional organisations. These include the Securities Commission Malaysia (Sukuk 2009: edited by Abdulkader Thomas; Introduction to Islamic Capital Market (2009); The Islamic Securities Market (2009); Valuation of Securities (2009); Regulatory Requirements, Legal Documentation, Accounting, Auditing and Taxation in the Islamic Capital Market (2009); International Sha'ria Research Academy for Islamic Finance (ISRA) (Islamic Financial System – Principles & Operations (2011); the various Standards issued by the Islamic Financial Services Board (IFSB), the prudential and supervisory standard-setting body for the global Islamic finance industry; the various Standards on Sukuk (14 in all) issued by AAOIFI especially the one on Shari'a Standards (2003-4) which deals extensively with the Shariah aspects of Sukuk structures, Sukuk and their Contemporary Applications, and the AAOIFI Sukuk Ruling (February 2008), which discussed the question of purchase undertakings and guaranteeing of principal in Mudaraba and Musharaka Sukuk.

The AAOIFI literature promotes three objectives: to develop accounting and auditing standards relevant to Sukuk; to disseminate Shari'a-compliant accounting and auditing applications; and to interpret and review Shari'a-compliant accounting and auditing standards.

Authors such as Jabeen (2009), in addition, have analysed the contemporary Sukuk issuances and their adherence to the AAOIFI Shari'a standards and their understanding of Basel II framework on securitisation.

Al-Suwailem (2000) similarly has studied the Shariah compliance aspects of Sukuk structures, especially in relation to Gharar and how to distinguish between speculative gambling and risk-averse choices and strategies. The writer examines in detail this point and suggests the need for more research on the applicability of Sukuk issuances by testing their legal structures in relation to the Standards issued by AAOIFI (2002).

The **third category** comprises a review of the literature published by Sukuk issuers, originators, corporates, listing exchanges, payment settlement agencies and allied services such as law firms, accountancy and auditing firms, consultancies, rating reports et al. These include the offer documents, prospectuses, term sheets, rating reports, fatwas on Sukuk structures, listing reports, corporate press releases, annual reports and interviews. The literature ranges from technical details as in the prospectuses and term sheets, rating reports, legal and regulatory reports and market reports. They however also comprise promotional corporate information regarding the Sukuk structures and issuances usually to promote a particular transaction or structure.

These include Sukuk originators such as SABIC, SEC, DAAR, Saudi Hollandi; rating agencies such as Standard & Poor's, Moody's and Fitch; law firms such as Norton Rose, White & Case, Clifford Chance, Trowers & Hamlins et al; auditing firms and consultancies such as KPMG, Ernst & Young, PriceWaterhouseCoopers; and stock exchanges such as Tadawul, Nasdaq Dubai etc.

The **fourth category** covers the literature in the print, broadcast and internet media relating to the Sukuk industry. They include news articles, features, comment in papers such as Arab News, Saudi Gazette, Khaleej Times, Islamic Finance News, Financial Times etc; in magazines such as Islamic Banker, Islamic Banking & Finance, Middle East Banker, Islamic Finance etc; online media outlets such as Zawya, AME Info, MenaFN etc; and news services such as Bloomberg, Thomson Reuters, Bernama etc.

The quality and depth of analysis depends on the particular publication or website and the author or institution. Media discussion of the technical issues relating to the Sukuk industry in general has been under-developed and limited partly because of the lack of experienced financial journalists and analysts specialising in Islamic finance.

What is the mechanism for structuring Sukuk?

Sukuk are based on the following basic principles:

- i) Transparency of privileges and unambiguous responsibilities for stakeholders.
- ii) The return on Sukuk funds must originate from the purpose of their issuance.
- iii) Sukuk must be backed by genuine underlying assets.

What are the differences between Sukuk and conventional bonds and the conventional securitization processes?

As Sukuk are defined as certificates of ownership of a pool of underlying assets and bonds are merely contractual debt obligations by the issuer, the relationship of Sukuk to conventional debt instruments: Sukuk are only distinct from bonds in terms of contract legitimacy and Shariah-compliance and not in terms of financial perspective. This is what makes Sukuk so popular within the conventional financial industry. Sukuk contracts show some similarities to those of conventional debt instruments as they share many features, especially assets-backed bonds. Furthermore, the common features are rooted from the same structural necessities (Islamic Finance, 2004). Cakir and Raei (2007) see Sukuk as parallel to conventional bonds when it comes to aspects such as rating, issuance and redemption procedures, coupon payments, and default clauses.

A bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal, whereas, the Sukuk are different by granting more rights for their holders to claim an undivided beneficial ownership in the underlying assets. Consequently, Sukuk holders are entitled to partnership in the revenues generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of the Sukuk assets proportionate to their contribution. This is the main distinction of obligation between Sukuk and bonds (Islamic Bonds, 2004).

Thomas and Adam (2004) compare the differences and similarities between Sukuk and conventional fixed-income products in the following way:

a) The Ownership Issue:

Sukuk symbolizes an ownership share in underlying assets monetized for the purpose of originating the cash flow/revenues requirement for funding of a clearly-defined Shariah-compliant project that would add genuine value to the economy and therefore the community. This is the most important principle that differentiates Sukuk contracts from those of interest based conventional bonds (AAIOFI, 2003).

The underlying assets must be Shariah-acceptable in terms of their character and application. The value and pricing of Sukuk are linked to their underlying assets. The market value appreciation and depreciation are not evaluated until the end of the investment cycle. Thus, Sukuk are not linked to their underlying market assets. This sensible form of financing facilitates a pioneering method for highlighting the importance of genuine asset collateralization to minimize speculation, which increases risk exposure for some parties involved (AAIOFI, 2003).

However, on the other side, in a standard conventional bond (security) issue, the authorized issuer (borrower) owes the bond holders (lenders) a debt and is obliged to repay the principle and interest (coupon), on maturity. Bonds symbolize the earning of

pure money on money, which is a classical usury-based (Riba-based) debt obligation due from the issuer to the investors or bond holders (Islamic Finance, 2004).

This represents a case of economic and social exploitation according to Islamic ethical values. Furthermore, the ownership of the bond is solely supported by the creditworthiness of the issuer without any relationship to the assets. Consequently, in case of the issuer's default, unsecured bond holders join the pool of general creditors seeking the assets of a defaulting issuer (Thomas and Adam, 2004).

Furthermore, bond-holders are totally disengaged from asset related expenses, making way for the use of speculative financial tools with minimal transparency, which is considered to be unhealthy because this causes volatility in the capital market. Although other Sukuk and bonds stipulations may require the issuer to provide certain information to the Sukuk and bond holders, or limitations on the behaviour of the issuer, such stipulations do not provide sufficient transparency for high risk long term debt securities (Islamic Finance, 2004) .

The framework of bonds which guarantees the principal is considered unacceptable and unethical, as they are seen as exploitive. According to Justice Taqi Usmani, a noted Shariah scholar, bond-holders in conventional financial institutions are merely givers of the loan for the sponsors of enterprises, and the interest on their loans is a percentage pegged with the price of interest in the market. Thus, the interest-based system dominant in the world today frequently issues bonds that produce interest from capital-intensive enterprises that bring regular guaranteed and absolute returns. In addition, bonds can be issued for finance for almost any purpose which is deemed to be legal in any global jurisdiction (Oakley, FT, 2008).

One other major difference between Sukuk and bonds is that the characteristics and servicing of the underlying assets must be Shariah-compliant for Sukuk. However, bonds

can be issued for the financing of any sort of project involving non-Shariah-compliant products and/or services such as alcohol production, casinos and gambling, weaponry, pornography, pork-related products and conventional financial services (Islamic Finance, 2004).

In a statement in 2008, Usmani commented that most of the contemporary economics of Sukuk has all the characteristics of conventional bonds in terms of structure, operation and purposes. He argued that Sukuk should be resurrected with the intention of supporting an Islamic economic system, which is based on the Shariah principles of social justice, which promotes entrepreneurship for a healthy business environment. However, he insisted that the current Sukuk structures have origins essentially similar to the conventional interest-based bonds, which has led to the matching financial results of Sukuk and interest-based conventional bonds. Unfortunately, such similarities are triggering disagreements about the actual need for Sukuk when they are so similar to bonds. Hence, it is imperative to standardize the basic Sukuk contracts, allowing some room for innovation, in order to minimize unhealthy disagreements over Sukuk structures, and to ensure that they rest on solid foundations (Oakley, FT, 2008).

b) The Risk/Return issue:

Choudhary (2001) stresses that as long as the Islamic economy is dictating the use interest-free instruments for a profit-loss sharing purpose, then it could be the basis for participatory and cooperative joint ventures. Balancing risk and return can be a tricky operation. All investors want to maximize their return, while minimizing risk. Many investors think of bonds as conservative investments, but the returns can have a high degree of volatility. The fluctuation of interest rates, or interest rate risk, and a downturn in the bond prices could significantly decrease the overall return of any particular bond.

What is more, the issuer default and the absence of collateral is the main risk posed by bonds. At most the risk/ return structures of Sukuk are almost analogous to conventional

bonds. Usmani asserts that most of the Sukuk that have been issued are indistinguishable from bonds in terms of the allocation of return from their projects as fixed percentages based on interest rates (LIBOR) benchmark (Oakley, FT, 2008).

Nonetheless, Mardam-Bey (2007) believes that Sukuk are priced competitively in line with conventional bond issues with regular periodic income for Sukuk certificate holders during the investment course.

Sukuk generally have a better risk profile than bonds supported with mandatory underlying assets to reduce risk exposure.

c) Guaranteeing the Principle Issue:

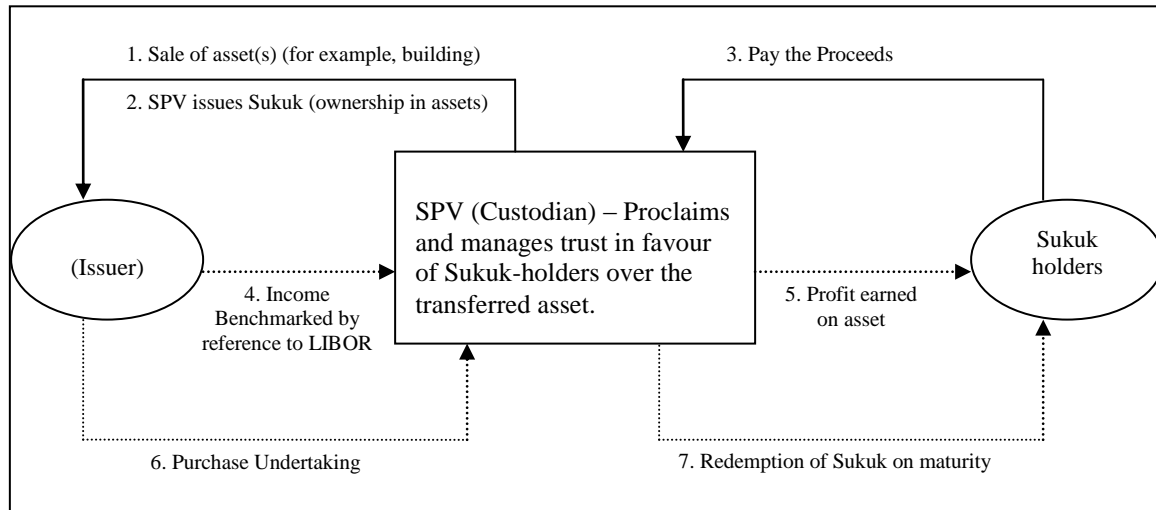
Although risk management is essentially acceptable and encouraged in Islamic economics, as long as there are no conflicts with Islamic principles, Usmani claims that most of the recent Sukuk contracts issued are capital guaranteed at maturity, the same as conventional bonds contracts (Bakar, 2007).

The prevailing Sukuk contracts currently, as illustrated by the author in figure 2.1, are obligations with a promise from either the issuer or the manager to repurchase the assets monetized by the Sukuk at face value regardless of the assets' market value at maturity.

It is worth mentioning that some experienced scholars in the sector believe that the general structures and mechanisms used in Sukuk today fail the test of Shariah standards and objectives, and portray Sukuk as being identical with conventional bonds in terms of their economic results. From the perspectives of Islamic jurisprudence and economics, these Sukuk structures do not incorporate the genuine spirit of Islamic financing (Merzaban, 2009).

Typical Sukuk Structure

Figure 2.1 Standard Sukuk Structure



Islamic financing is principally based on asset mobilization through profit and loss sharing and risk distribution among shareholders based on Shariah financial principles. The aim is to minimize risk exposure for all stakeholders for the good of the community and provide an incentive for entrepreneurs to produce genuine assets.

Therefore, securitized Sukuk as Islamic financing instruments via the creation of a Special Purpose Vehicle (SPV) are considered custodians and have been robustly promoted on the basis of Islamic financial ethics to contain and avert speculation, high debt levels, and interest and market uncertainty. In Saudi Arabia, one of the promising potentially largest markets for Sukuk origination, SPV laws are in need of restructuring to laws to protect family wealth and to guarantee that property assets pass to the next generation with the least difficulties would promote the popularity of Sukuk among family trust companies. Sukuk are an ideal asset class for investment and the operation of a vibrant capital market. That is why innovative structuring and effectively crafted

securitisation could establish a solid base for Sukuk in the capital market of Saudi Arabia (Volaw, 2011).

Jobst, Kunzel, Mills and Amadou (2007), believe that Sukuk are operating similarly to conventional asset-backed securities but are structured to ensure their contracts' compliance with Islamic financial standards, which, among other provisions, prohibit the receipt and payment of interest and stipulate that income must be derived as profits from shared business risk rather than guaranteed return. Yet, Sukuk can provide efficient management and a source of various financing arrangements that can be structured in a manner that will lessen the costs and increase the marginal profits of companies in a contained risk environment.

Nevertheless, Rodney Wilson (2004) predicts a great challenge arising from disagreements among Shariah scholars with regard to the Shariah authenticity of Sukuk structures and products, which is causing confusion among investors. Similarly, Usmani, Head of the Shariah Committee at AAIOFI, claimed in 2007 that most issued Sukuk in the Gulf are non-Shariah compliant. This affected new originations in the global Sukuk market. It is suggested that Shariah compliance within the Islamic finance industry must be adopted systematically with Apex Shariah institutions in each region with the authority to provide the final approval of any Shariah-compliant financial products and services.

Conversely, Rasheed Al-Maraj (2005), currently Governor of the Central Bank of Bahrain, does not recommend general Sukuk standardization as it would impose homogeneity across the board and minimize diversification of Sukuk products and services. However, he emphasizes the importance of standardization of core contracts, instruments, documentation and disclosure practices that are key to ensuring market transparency and investors' confidence and for local and international recognition. According to Robin Wigglesworth (2006), this requires experienced lawyers in both domains who can bridge the differences between Shariah standards and commercial laws. Chris Sioufi, a partner at DLA, the world's second largest law firm says: "A good Islamic lawyer is one that can do both conventional and Islamic finance."(CPI Financial, 2006)

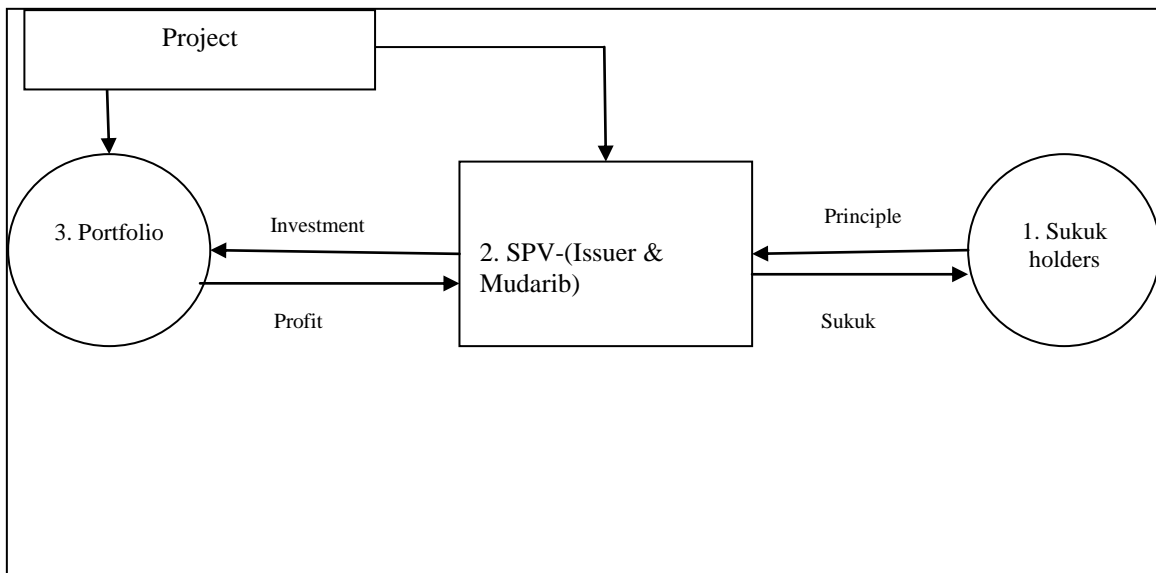
Types of Sukuk and their Structure and Mechanism

Sukuk can be of many types depending upon the Islamic mode of financing used in their structuring. However, the most common and important among those used are Ijarah, Musharakah, Salam and Istisna Sukuk (Reuters, 2011). Among the fourteen eligible Sukuk identified by the AAOIFI, the following are the most common:

a) Mudaraba Sukuk (AAIOFI, 2003)

These are a participatory type of investment Sukuk that represent ownership of units of equal value in the Mudaraba equity and are registered in the names of holders on the basis of undivided ownership of shares in the Mudaraba equity and its returns according to the percentage of ownership of share. The owners of such Sukuk are the Rabbul-mal (financier). Mudaraba Sukuk are used for enhancing public participation in mega-investment projects (Mohamed, 2008).

Figure 2.2 Mudaraba Sukuk Structure



The following are the significant features of Mudaraba Sukuk (Islamic Bond, 2004):

- Mudaraba Sukuk represents common ownership and entitles their holders to a share in the specific projects against which the Mudaraba Sukuk have been issued.
- The Mudaraba Sukuk contract is based on the official notice of the issue of the prospectus which must provide all information required by the Shariah for the Qirad contract such as the nature of capital, the ratio for profit distribution and other related conditions. According to Choudhary (2001), Mudaraba Sukuk promotes partnership; but the dilemma of measurement, and the imprecision of profit and loss sharing, leads to major obstacles thus preventing Mudaraba Sukuk from progressing. Hence, a sustainable system of allocating the return on capital and labour resources is an essential issue in Mudaraba Sukuk.

As illustrated by the author's own in figure 2.2, the Mudaraba Sukuk holder is given the right to transfer the ownership by selling the deeds in the securities market at his discretion. The sale of Mudaraba Sukuk must follow the rules listed below:

- i) If the Mudaraba capital, before the operations of the project, is still in the form of money, the trading of Mudaraba Sukuk would be like exchange of money for money. In that case the rules of Bay al-Sarf would be applied.
- ii) If Muqarda (bartering) capital is in the form of debt then it must satisfy the principles of debt trading in Islam.
- iii) If capital is in the form of a combination of cash, receivables, goods, real assets and benefits, trade must be based on a market price agreed by mutual consent.

The Manager/SPV who manages the funds of the subscribers to the Mudaraba Sukuk can also invest from his own fund. He will get a profit for his capital contribution in addition to his share in the profit as a Mudarib.

Mudaraba Sukuk should contain a guarantee provided by the underlying assets, from the issuer or the manager of the fund, for the capital, whatever the return or profit, or a profit based on any percentage of the capital is not guaranteed. Accordingly;

- The prospectus or the Mudaraba Sukuk issued pursuant to it, may not stipulate payment of a specific amount to the Mudaraba Sukuk holder,
- The profit is to be divided from an amount in excess of the capital, and not from the revenues or the yield; and
- The Profit and Loss account of the project must be published and disseminated to Mudaraba Sukuk holders.

It is permissible to create reserves for contingencies, such as loss of capital, by deducting from this from the profit. The prospectus can also contain a promise made by a third party, totally unrelated to the parties to the contract, in terms of legal entity or financial status, to donate a specific sum, without any counter benefit, to meet losses in the given project, provided such commitment is independent of the Mudaraba contract.

On the expiry of the specified time period of the subscription, the Sukuk holders are given the right to transfer the ownership by sale or trade in the securities market at their discretion. Steps involved in the structure:

- Mudarib enters into an agreement with project owner for construction/ commissioning of project.
- SPV issues Sukuk to raise funds.
- Mudarib collects regular profit payments and final capital proceeds from project activity for onward distribution to investors.
- Upon completion, Mudarib hands over the finished project to the owner.

Mudaraba Sukuk Example:

The Saudi Hollandi Bank (SHB) (Issuer) in 2008 and 2009 offered investors (Sukuk holders) to subscribe to Mudaraba Sukuk, the proceeds of which was used in its Islamic banking business portfolio. The Sukuk holders via the Sukuk holders' agent (Wakeel) appointed SHB as Mudarib to manage the funds raised through a Mudaraba Sukuk. The

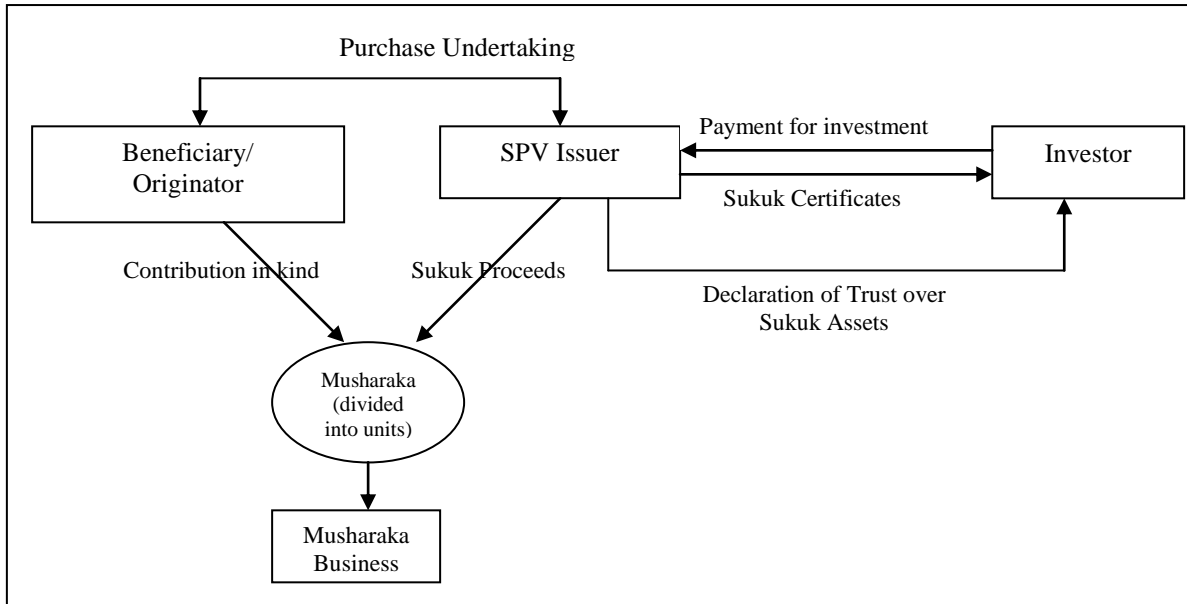
Mudaraba Agreement signed between the Mudarib and Sukuk holders' agent regulates the conduct of the Mudarib. Profit generated from the portfolio is distributed among Sukuk holders and the issuer. The Sukuk holders receive a return (periodic distribution amount) (Goud, 2010).

b) Musharaka Sukuk (AAIOFI-approved Variant, 2003)

These are a participatory type of investment Sukuk that are based on profit-sharing terms and represent an ownership of Musharaka equity. They do not differ from the Mudaraba Sukuk except in the organization of the relationship between the party issuing such Sukuk and holders of these Sukuk, whereby the party issuing Sukuk forms a committee drawn from the holders of the Sukuk who can be referred to in investment decisions (AAOIFI, 2003).

Musharaka Sukuk are the second most popular type of Sukuk structures used after Ijara Sukuk. They are used for mobilizing funds for establishing a new project or developing an existing one, or financing a business activity on the basis of equity partnership. The certificate holders become the owners of the project or the assets of the activity as per their respective shares as they are all considered to be financiers. These Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

Figure 2.3 Musharaka Sukuk Structure



Source: (Clifford Chance, 2006)

Nonetheless, Choudhary (2001) considers that Musharaka Sukuk face an identical problem to that faced by Mudaraba, which is the ownership and income/wealth allocation. Therefore, extensive research on developing a universally acceptable Musharaka Sukuk contract remains a major challenge. In today's modern companies, similar programs such as employees' shares equity programs are being adopted as they have proven to be successful in motivating employees and improving productivity.

“These (Musharaka Sukuk) are certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any partnership contracts so that the certificate holders become the owners of the project or assets of the activity as per their respective shares, with the Musharaka certificates being managed on the basis of participation or Mudaraba or an investment agency” (AAOIFI, 2003).

Musharaka Sukuk are investment Sukuk that represent ownership of Musharaka equity, which is in the nature of a joint venture agreement between the issuer and the originator to engage in a Shariah-compliant investment business for an agreed profit share distribution. Mudaraba and Musharaka acquired popularity due to the fact that they allow Sukuk to be issued without being entirely dependent on underlying assets in order to generate a return for Sukuk holders.

Steps involved in the Musharaka Sukuk:

As illustrated by Clifford Chance in figure 2.3, while the Shariah perceives the Musharaka to be an independent entity, it is not a legal entity in its own right under dominant jurisdictions like English law, and would simply be construed as an agreement between two parties.

Corporates and the Special Purpose Vehicles (SPVs) enter into a Musharaka partnership arrangement as a form of joint venture for a fixed period and an agreed profit-sharing ratio. Also, the corporate undertakes to buy Musharaka shares of the SPV on a periodic basis. The following are some cases where Musharaka Sukuk can be developed:

- i) Corporate (as Musharik) contributes land or other physical assets to the Musharaka.
- ii) SPV (as Musharik) contributes cash i.e. the issue proceeds received from the investors to the Musharaka.
- iii) The Musharaka appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharaka and sell/lease the developed assets on behalf of the Musharaka.
- iv) In return, the agent (i.e. the Corporate) will get a fixed agency fee plus a variable incentive fee payable.
- v) The profits are distributed to the Sukuk holders.

- vi) The Corporate irrevocably undertakes to buy at a pre-agreed price the Musharaka shares of the SPV on periodic basis and at the end of the fixed period the SPV would no longer have any shares in the Musharaka.

Musharaka Sukuk example

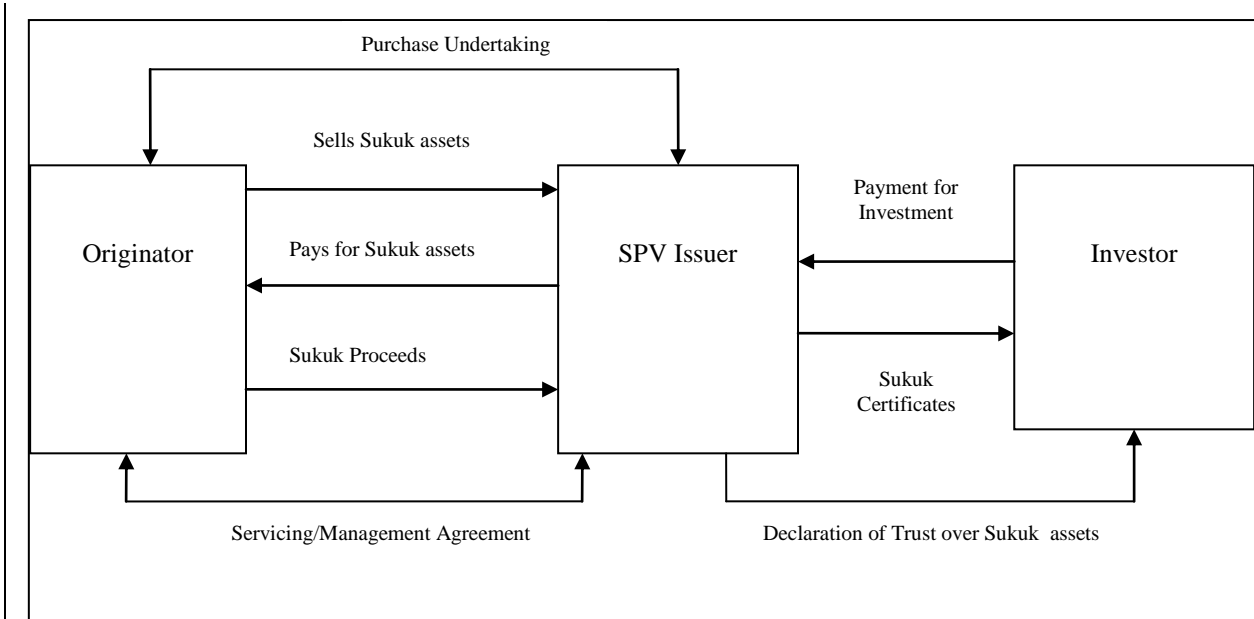
An US\$550 million Sukuk transaction for Emirates Airline closed in 2005; the seven-year deal was structured on a Musharaka basis. The Musharaka or joint venture was set up to develop a new engineering centre and headquarters building on land situated near Dubai Airport which will ultimately be leased to Emirates.

Profit, in the form of lease rentals, generated from the Musharaka venture will be used to pay the periodic distribution on the trust certificates. The largest Sukuk Al-Musharaka transaction has been a US\$3.5b Sukuk for Ports, Costume & Free Zone (Dubai Ports World) in 2006 (Clifford Chance, 2006).

c) Ijarah Sukuk (AAIOFI, 2003)

Ijarah Sukuk are based on sale and leaseback representing an ownership of equal shares in rented assets or the usufruct of assets. These Sukuk give their owners the right to own real estate, receive the rent and dispose of their Sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable.

Figure 2.4 Ijarah Sukuk Structure



Source: (Clifford Chance, 2006)

Ijarah Sukuk as illustrated by Clifford Chance (2006) in Figure 2.4, are securities representing ownership of clearly defined existing and known assets tied to a lease contract, rental of which is the return payable to Sukuk holders. Payment of Ijarah rentals can be unrelated to the period of taking usufruct by the lessee. Such payment can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide. The holders of such Sukuk bear all costs of the maintenance of and damage to the real estate (AAOIFI, 2003).

This flexibility can be used to evolve different forms of contracts and Sukuk that may serve the different purposes of the issuers and the holders, and that is why Ijarah has been the most commonly used type of Sukuk structure in the Islamic debt capital markets in the last few years. Furthermore, Clifford Chance believes that Sukuk Al-Ijarah is a hybrid structure between an operational lease and finance/capital lease with certain ‘ownership’ risks such as maintenance and insurance of the undertaken assets. In addition, the lessor

may appoint an agent; it could be the lessee itself, to manage such risk on behalf of the lessor.

Features of Ijarah Sukuk

- i) It is necessary in an Ijarah contract that the assets being leased and the amount of rent are clearly defined to the parties at the time of the contract, and if both of these are known, Ijarah can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee. The lessor can sell the leased asset provided it does not hinder the lessee from taking benefit from the asset. The new owner would be entitled to receive the rentals (AAOIFI, 2003).
- ii) Rental conditions in Ijarah must be stipulated in clear terms for the first term of the lease, and for future renewable terms, it could be constant, increasing or decreasing by benchmarking or relating it to any well-known variable.
- iii) As per Shariah rules, expenses related to the body or basic characteristics of the assets are the responsibility of the owner, while maintenance expenses related to its operation are to be borne by the lessee.
- iv) As regards procedure for issuance of Ijarah Sukuk, an SPV is created to purchase the asset(s), which in turn issues Sukuk to the investor, enabling it to make payment for purchasing the asset. The asset is then leased to third party for its use. The lessee makes periodic rental payments to the SPV that in turn distributes the same to the Sukuk holders.
- v) Ijarah Sukuk are negotiable and can be traded in the secondary market.
- vi) Ijarah Sukuk offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, Awqaf or any other private or public entities can issue these Sukuk. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.

Steps involved in the structure

- i) The obligor sells certain assets to the SPV at an agreed pre-determined purchase price.
- ii) The SPV raises financing by issuing Sukuk certificates in an amount equal to the purchase price.
- iii) This is passed on to the obligor (as seller).
- iv) A lease agreement is signed between SPV and the obligor for a fixed period of time, where the obligor leases back the assets as lessee.
- v) SPV receives periodic rentals from the obligor;
- vi) These are distributed among the investors i.e. the Sukuk holders.
- vii) At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the Ijarah Sukuk.

Ijarah Sukuk example

In 2004, Sarawak Economic Development Corporation (SEDC) raised US\$350 million from the market through a Sukuk Al-Ijarah Trust Certificates issuance by its SPV, Sarawak Corporate Sukuk Inc. (SCSI). The certificates were issued with a maturity of 5 years and under the proposed structure, the proceeds will be used by the issuer to purchase certain assets from 1st Silicon (Malaysia) Sdn Bhd. Thereafter, the issuer will lease assets procured from 1st Silicon to SEDC for an agreed rental price for an agreed lease period of 5 years.

Issues for Consideration in an Ijarah Sukuk

Clifford Chance (2006) has raised several issues relating to the Ijarah Sukuk. They include:

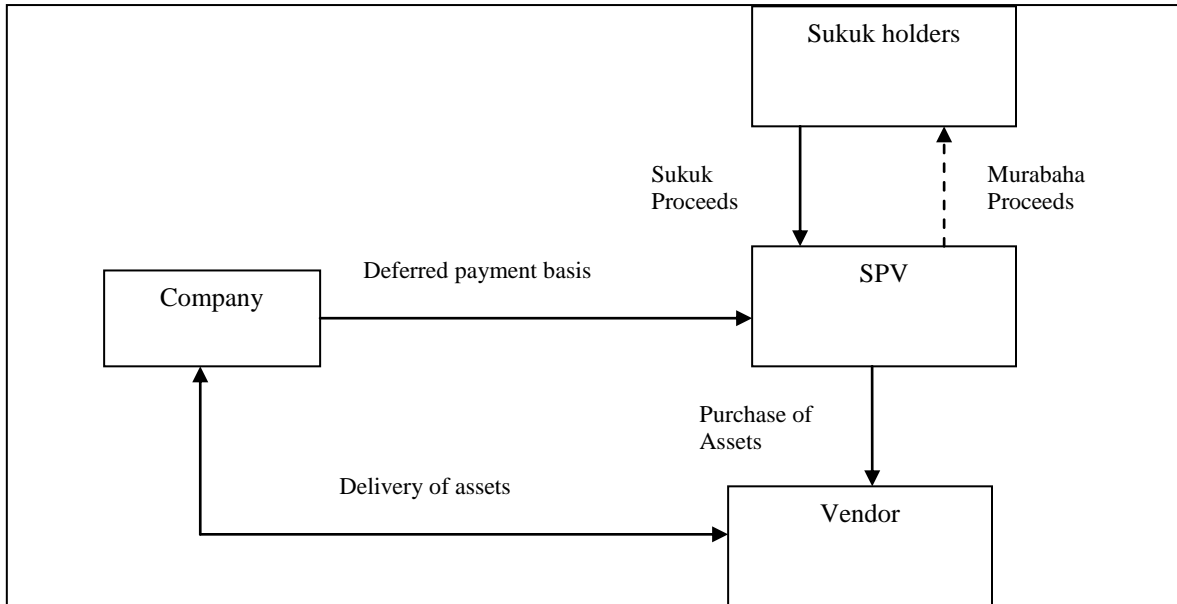
- i) Sukuk necessitate 'True Transfer' of the real assets, yet this is not the case, as the sale is not perfected. Hence, a Sukuk Al-Ijarah note is not an asset backed bond (here it is better described as an asset based issue).
- ii) the size of Sukuk is restricted by the value of the assets that are being transferred by the originator to the special purpose vehicle, which means that if the assets have been used for the Sukuk issue they cannot be used for any other purpose until the Sukuk issue is matured; and
- iii) the probable tax implications of such unperfected asset transfer still need to be examined on a case by case and jurisdiction by jurisdiction basis

d) Murabaha Sukuk (AAIOFI, 2003)

In this case the issuer of the certificate is the seller of the Murabaha commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the Murabaha commodity and are entitled to its final sale price upon the re-sale of the Commodity.

The possibility of having legally acceptable Murabaha-based Sukuk is only feasible in the primary market. The negotiability of these Sukuk or their trading on the secondary market is not permitted by Shariah, as the certificates represent a debt owing from the subsequent buyer of the commodity to the certificate-holders. Such trading amounts to trading in debt on a deferred basis, which will result in Riba.

Figure 2.5 Murabaha Sukuk Structure



Source: (Global Investment House, 2008)

Despite being debt instruments, the Murabaha Sukuk could be negotiable if they are the smaller part of a package or a portfolio as illustrated by Global Investment House in figure 2.5. The larger part of which is constituted of negotiable instruments such as Mudaraba, Musharaka, or Ijarah Sukuk. Murabaha Sukuk are popular in Malaysian market due to a more liberal interpretation of Fiqh by Malaysian jurists permitting sale of debt (bai-al-dayn) at a negotiated price.

Steps involved in the structure

- i) A master agreement is signed between the SPV and the borrower
- ii) SPV issues Sukuk to the investors and receives Sukuk proceeds.
- iii) SPV buys commodity on a spot basis from the commodity supplier.
- iv) SPV sells the commodity to the borrower at the spot price plus a profit margin, payable on instalments over an agreed period of time
- v) The borrower sells the commodity to the commodity buyer on a spot basis.

vi) The investors receive the final sale price and profits.

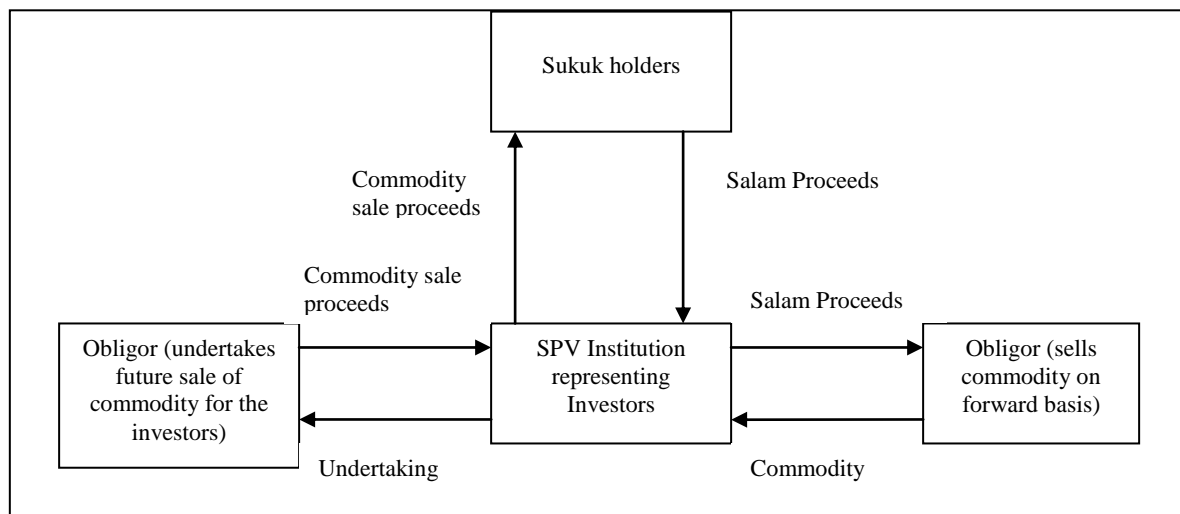
Murabaha Sukuk Example

Arcapita Bank, a Bahrain-based investment bank, mandated Bayerische Hypo-und Vereinsbank AG (“HVB”), Standard Bank Plc (“SB”) and WestLB AG, London Branch (“WestLB”) (together the “Mandated Lead Arrangers”), to arrange a Five Year Multi-currency (US\$, € and £) Murabaha-backed Sukuk. Sukuk had a five-year bullet maturity and proposed pricing three month LIBOR +175bps (2005).

e) Salam Sukuk (AAIOFI, 2003)

Salam Sukuk are certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to the ownership of the certificate holders. As illustrated by Islamic Bonds in figure 2.6, the issuer of the certificates is a seller of the goods of Salam; the subscribers are the buyers of the goods, while the funds realized from the subscription are the purchase price (Salam capital) of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any. Nevertheless, Salam Sukuk are non tradable as they are considered to be a receivable.

Figure 2.6 Salam Sukuk Structure



Source: (Islamic Bonds, 2004)

Salam-based securities may also be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the SPV in return for a promise to deliver a commodity at a future date. An SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the Sukuk.

All standard Shariah requirements that apply to Salam also apply to Salam Sukuk, such as, full payment by the buyer at the time of affecting the sale, standardized nature of underlying asset, clear enumeration of quantity, quality, date and place of delivery of the asset.

One of the Shariah conditions relating to Salam, as well as for creation of Salam Sukuk, is the requirement that the purchased goods are not re-sold before actual possession at maturity. Such transactions amount to selling of debt. This constraint renders the Salam instrument illiquid and hence somewhat less attractive to investors. Thus, an investor will buy a Salam certificate if he expects prices of the underlying commodity to be higher on the maturity date.

Steps involved in the transaction:

- i) SPV signs an undertaking with an obligor to source both commodities and buyers. The obligor contracts to buy, on behalf of the end-Sukuk holders, the commodity and then to sell it for the profit of the Sukuk holders.
- ii) Salam certificates are issued to investors and SPV receives Sukuk proceeds.
- iii) The Salam proceeds are passed onto the obligor who sells commodity on forward basis
- iv) SPV receives the commodities from the obligor
- v) Obligor, on behalf of Sukuk holders, sells the commodities for a profit.

vi) Sukuk holders receive the commodity sale proceeds.

Salam Sukuk Example

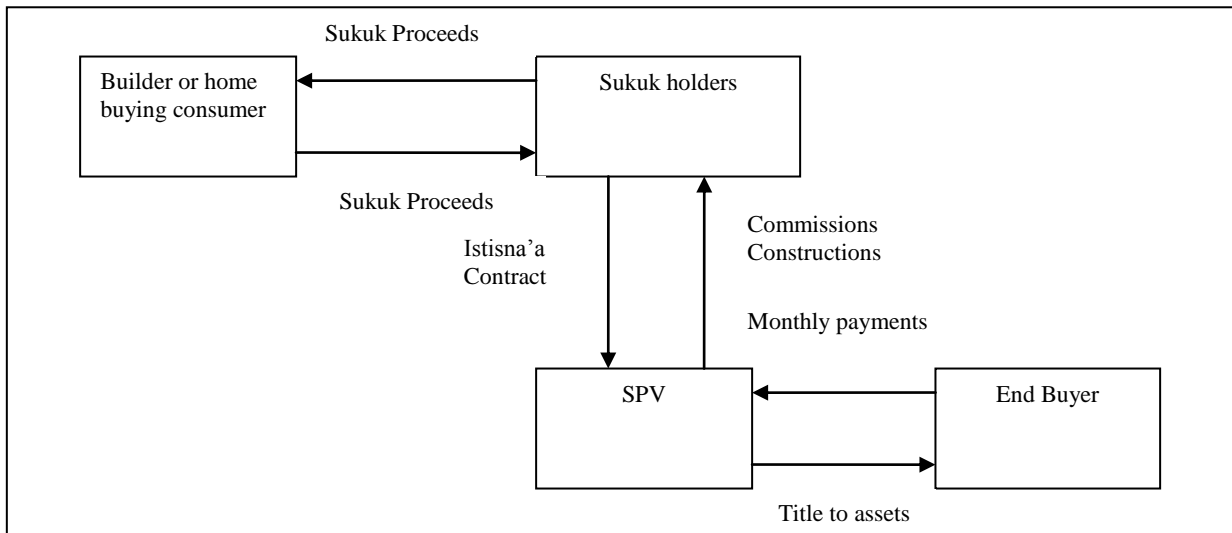
In the case of Bahrain, Aluminium was designated as the underlying asset of the Bahrain government Salam Sukuk contract, whereby it promises to sell Aluminium to the buyer at a specified future date in return for a full price payment in advance. The Bahrain Islamic Bank (BIB) was nominated to represent the other banks wishing to participate in the Al Salam contract. BIB was delegated to sign the contracts and all other necessary documents on behalf of the other banks in the syndicate. At the same time, the buyer appointed the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution. The Government of Bahrain provided an additional undertaking to the representative (BIB) to market the Aluminium at a price, which will provide a return to Salam Sukukholders equivalent to those available through other conventional short-term money market instruments.

e) Istisna Sukuk (AAIOFI, (2003)

Istisna Sukuk are certificates that carry equal value and are issued with the aim of mobilising the funds required for producing products that are owned by the certificate holders. The issuer of these certificates is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realised from subscription are the cost of the product.

The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a Parallel Istisna, if any. Istisna Sukuk are useful for financing large infrastructure projects. The suitability of Istisna for financial intermediation is based on the permissibility for the contractor in Istisna to enter into a parallel Istisna contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub-contract the actual construction to a specialised firm.

Figure 2.7 Istisna' Sukuk Structure



Steps involved in the structure as illustrated by the author's own in figure 2.7:

- i) SPV issues Sukuk certificates to raise funds for the project.
- ii) Sukuk issue proceeds are used to pay the contractor/builder to build and deliver the future project.
- iii) Title to assets is transferred to the SPV
- iv) Property/project is leased or sold to the end buyer. The end buyer pays monthly instalments to the SPV.
- v) The returns are distributed among the Sukuk holders.

Istisna Sukuk Example:

Tabreed's five-year global corporate Sukuk (on behalf of the National Central Cooling Company, UAE) provided a fixed coupon of 5.50% (2004). It is a combination of Ijarah Istisna and Ijara Mawsufah fi al Dhimmah (or forward leasing contracts). The issue was launched to raise funds to retire some existing debt, which totals around US\$136 million, as well as to finance expansion.

The Durrat Sukuk financed the reclamation and infrastructure for the initial stage of a broader US\$ 1 billion world class residential and leisure destination known as 'Durrat Al Bahrain', currently the Kingdom of Bahrain's largest residential development project. The return on the Sukuk is 125 basis points over 3 months LIBOR payable quarterly, with the Sukuk having an overall tenor of 5 years and an option for early redemption.

The proceeds of the issue (cash) were used by the issuer to finance the reclamation of the land and the development of Base Infrastructure through multiple project finance (Istisna) agreements. As the works carried out under each Istisna are completed by the contractor and delivered to the Issuer, the Issuer will give notice to the Project Company under the Master Ijarah Agreement and will lease such base infrastructure on the basis of a lease to own transaction.

f) Hybrid Sukuk (AAIOFI, 2003)

Due to the fact that Sukuk issuance and trading are important means of investment and fund raising, and taking into account the various demands of investors, a more diversified Sukuk - hybrid or mixed asset Sukuk – has materialized in the market. In a hybrid Sukuk, the underlying pool of assets can encompass Istisna, Murabaha or Ijarah receivables.. Hybrid Sukuk are a portfolio of assets comprising diverse classes. Nevertheless, as Murabaha and Istisna contracts cannot be traded on the secondary market, the asset pool of a hybrid Sukuk must consist of at least 51% assets that are tradable in the market such as tangibles. Because of the Murabaha and Istisna receivables component of the asset pool, the return on these transactions can only be a pre-agreed fixed rate of return.

Steps involved in the structure:

- Islamic finance originator transfers assets as well as Murabaha deals to the SPV.

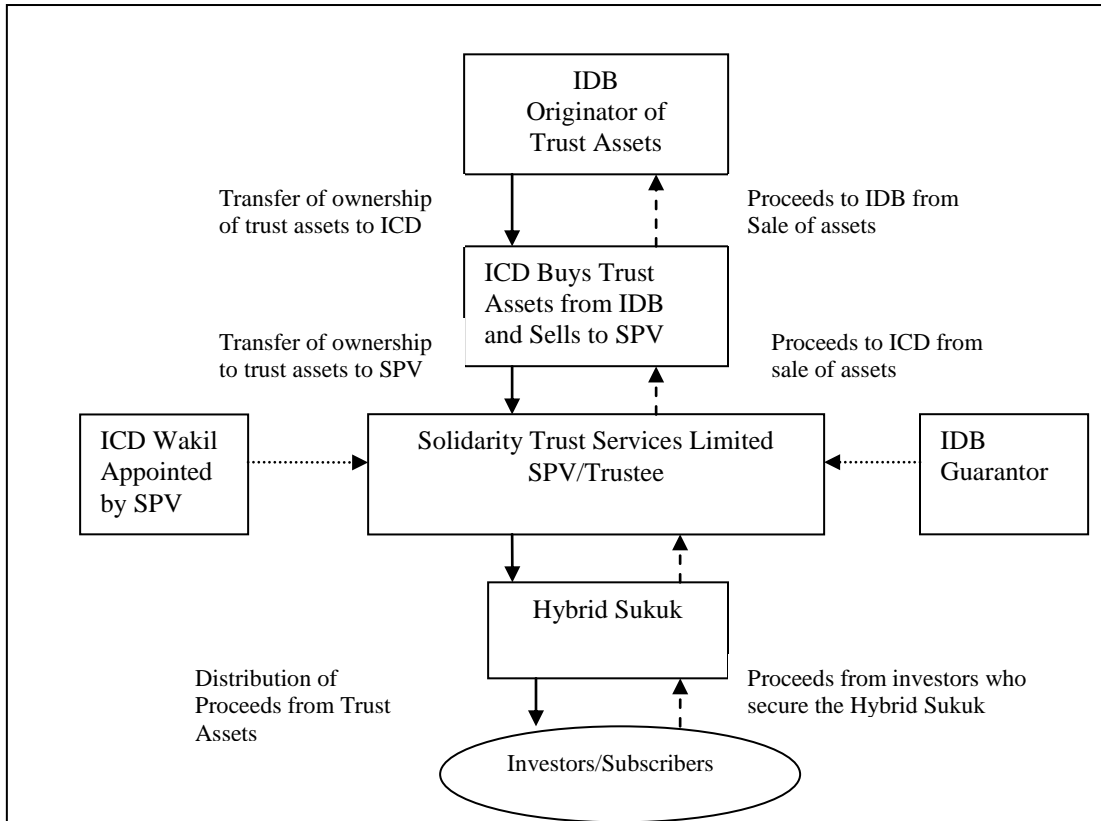
- The SPV issues certificates of participation to the Sukuk holders and receives funds. The funds are used by the Islamic finance originator.
- Islamic finance originator purchases these assets from the SPV over an agreed period of time.
- Investors receive fixed payment of return on the assets.

Hybrid Sukuk Example

As illustrated by AA Tariq in figure 2.8, the Islamic Development Bank (IDB) issued the first hybrid Sukuk with an asset pool comprising 65.8% Ijarah (leasing) contracts, 30.73% Murabaha (conditional sale) receivables, and 3.4% Istisna assets (2009). This issuance required the IDB's guarantee in order to secure a rating and international marketability.

The US\$400 million Sukuk was issued by Solidarity Trust Services Limited (STSL), a special purpose company incorporated in Jersey. The Islamic Corporation for the Development of Private Sector (ICD) played an intermediary role by purchasing the assets from the IDB and selling it to STSL at the consolidated net asset value. Return was quantified on 3.625% pa on a fixed basis to be distributed bi-annually and to be redeemed by August 2008.

Figure 2.8 Hybrid Sukuk Structure of IDB



Source: (AA Tariq, Sept. 2004)

Dynamics of Sukuk Pricing

As Sukuk issuance is comparatively new compared to conventional bonds, one of the main challenges facing Sukuk is how to identify a suitable benchmark to determine pricing.

JA Zaidi (2007) describes the key problems for the efficient functioning of Sukuk pricing as:

- i) Lack of a consensus on an Islamic benchmark rate. Instead the conventional market benchmark rate (such as LIBOR or EURIBOR) is used as a proxy to determine the pricing of the Islamic instruments,
- ii) Low liquidity, lack of market depth, a lack of critical mass of issuances and relatively small number of participants,

- iii) Lack of price validation mechanism which facilitates dissemination of news and upcoming issues
- iv) Absence of a focused risk based pricing mechanism (a demand for credit ratings with focus on Islamic finance can provide this mechanism)
- v) Risk mitigation to manage and hedge the risk of fluctuations in the market value of instruments on account of movements in benchmark rate
- vi) Limited choice of suitable assets to be used as collateral.

Additionally, with the increasing number of Sukuk issuances, Shariah has restrictions on trading indebtedness. Therefore, Deutsche Bank, Bond Market Guide (2007) has divided Sukuk contracts into two major categories in terms of their tradability in a secondary market with different pricing mechanism as follows:

- i) Tradable Sukuk at a market price: e.g. Sukuk Ijarah, Mudaraba and Musharaka; and
- ii) Transferable Sukuk at face value: e.g. Sukuk Murabaha and Istisna.

Furthermore, as credit rating is a major factor in gauging the pricing of traditional bonds, it is also a major factor in Sukuk pricing. Unfortunately, London Interbank Offered Rate (LIBOR) is the most common benchmark currently implemented in pricing Sukuk profit or rental-based return, which is undesirable because it is an interest-based benchmark. The Sukuk pricing process uses the same pricing mechanism as bonds, utilising the difference between bid and ask prices (generally called bid-ask spread), and is also determined by the trading volume. The latest SABIC Sukuk approved by the Saudi Capital Market Authority (CMA) was offered to the public on a book-building basis to draw more diversified investors' base other than the institutional investors.

Karen Lane stresses that instead of fixed annual interest rate payouts to investors over the life of the conventional bond, Sukuk returns are derived from leases, profit or sales of assets such as property, equipment or joint venture business. These leases, profits, or sales can be structured to deliver the equivalent of a fixed annual interest rate, yet they technically are not the forbidden "interest" payments.

Strategizing Sukuk pricing based on Shariah principles away from conventional debt financing benchmarks such as LIBOR is a major challenge facing the Islamic capital market. However, the bigger challenge is to establish a platform of pricing Sukuk on a daily basis for the purpose of facilitating Sukuk trading and establishing an active secondary market.

Dynamics of Sukuk Tenor

Sukuk duration has been classified by AAOIFI Shariah Standard (No. 18, 2003) as varying on the type of the contract of the issue. Sukuk issuance might be on a short, medium or long-term basis according to the issuers' requirements. In addition, Sukuk could be also issued without specification of a period of maturity. It is absolutely pivotal that Sukuk are structured to accommodate the dynamics of the capital market, as it is well known that the market rules by its demands for a variety of different needs.

Sukuk in general are also considered to be medium-long term in nature. Thus, Sukuk offers the best Shariah-compliant instruments offering short and long term solutions for liquidity management with competitive return in recognition of the net present value concept in Islamic finance.

On the other hand, Sukuk should be capable of offering a wide range of different durations from months to years in order for them to be able to compete with other similar conventional financing instruments. This is only to fill the gap presented by the rapidly increasing needs for versatile Shariah-compliant financing and investment instruments.

Sukuk Assets

As Islamic law recognizes private property rights, the major stipulation for issuance of Sukuk is the existence of eligible assets on the balance sheet of the issuing entity that wishes to mobilize its financial resources. Thus, the identification of a suitable asset that can generate returns to pay Sukuk holders, is the first and most important step in the process of structuring contracts for issuing Sukuk certificates. Asset monetization is the most important challenge when structuring Sukuk where loan contracts rely on the

principle of asset basing with an income derived from profit sharing ventures, instead of guaranteed returns from conventional asset-backed bonds.

With regard to Sukuk assets in Saudi Arabia, the first landmark public Sukuk issued in the Kingdom and approved by the CMA was for Saudi Arabian Basic Industries Corporation (SABIC) in July 2006 for a SAR3 billion (US\$800 million) issuance known as SABIC Sukuk-I. The second SABIC Sukuk was issued in June 2007 for SAR8 billion (US\$2.1 billion) as SABIC Sukuk II. The third SABIC Sukuk was issued in May 2008 for SAR5 billion (US\$1.3 billion) as SABIC Sukuk-III.

Islamic Finance News (2007) sees Istithmaar Sukuk (Investment Sukuk) as a unique structure tailor-made for SABIC. The pool of assets comprises percentage payment entitlements under SABIC's marketing agreements, which SABIC as a holding company has with its petrochemical affiliate producers. SABIC has transferred a percentage of these rights and obligations into the Sukuk via its business unit, which incurs certain costs and receives fees, through a similar custodian structure, SABIC, Sukuk LLC, a wholly owned subsidiary of the issuer as a special purpose vehicle (SPV) structure.

The life span of the structured Sukuk is to give Sukuk holders 20 years of right return with quarterly payment derived for a certain amount based on SIBOR, with the excess put-off as a reserve to cushion Sukuk holders if the certain amount is unlikely to be met. According to SABIC Sukuk Circular, in addition the money accruing to the reserve is used to pay out returns every five years during the 20year life of the Sukuk as well as an extra amount equal to 10% of the face of the value of the Sukuk. At the end of the Sukuk's life, an amount of 40% of the face value would have been paid to Sukuk holders. SABIC also gave itself the option of purchasing the Sukuk earlier than the 20-year lifespan with any remaining balance in the reserve paid to SABIC as incentive for its profitable marketing services.

Sukuk were also launched in 2007, 2008 and 2010 by the Saudi Electricity Company (SEC) "This is a ground-breaking transaction, not only in terms of size, but in terms of transaction structure, with the Sukuk assets consisting of SEC's meter reading and

maintenance tariffs relating to a specified pool of electricity meters,” says Andrew Coats (2007), partner at City-based international law firm Clifford Chance, describing the stand-alone SR5 billion public offer issuance announced by SEC, which matures in 2027. The Saudi Council of Ministers granted the SEC exclusive rights to supply and license to maintain and read electricity meters, and to distribute bills, with the related entitlement to levy and receive service charges. For that reason, the above asset pools contain hundreds of thousands of numbered electricity meters across Saudi Arabia (Coats, Andrew, 2007).

The underlying assets of Sukuk can be divided into four types:

- a) Sukuk representing ownership in tangible assets (mostly based on sales and lease back contracts or direct leases),
- b) Sukuk representing usufruct or services (based on sub leases or sale of services),
- c) Sukuk representing equity share in a particular business or investment portfolio,
- d) Sukuk representing receivables or future goods (based on Murabaha or Salam).

Importance of Rating Sukuk

In 2002, the then Bahrain Monetary Agency (now evolved into the Central Bank of Bahrain) and the Islamic Development Bank together with other shareholders established the Islamic International Rating Agency (IIRA) for the purpose of independently evaluating, analyzing and rating Islamic banks and instruments (Islamic Business & Finance, 2006).

This important step established a necessary benchmark for innovating, implementing and approving new Islamic investments in the nascent regional Sukuk markets. However, it is imperative that IIRA does not constrict the genuine spirit of Islamic finance on the basis of conservative interpretations of Fiqh-Al-Muamalat. Islamic financing innovation is the main goal, achieved by adopting and promoting new flexible contracts without compromising Shariah financial principles and the spirit of the Shariah.

From the perspective of the conventional rating agencies, the most important risk for Sukuk is the potential exposure to the return of the underlying assets where this return depends on the creditworthiness of the originator or the cash flow generated by the underlying assets, as well as the position of the Sukuk compared to other financial obligations of the originator.

Moody's unique Sukuk rating method is based on whether the Sukuk are assets-backed by relying on income streams on the underlying assets, or asset-based by relying on the originator for payment via a repurchase undertaking, even though all transactions are likely to involve a set of underlying asset risk which is shared by the issuer and investors. Moody's emphasises the importance of the underlying assets as the backbone of the Sukuk principal repayment and the applicable law.

Despite the fact that the Sukuk market is still nascent in Saudi Arabia, more issues like the Saudi Arabian Basic Industries Corporation (SABIC) Sukuk, Saudi Electricity Company (SEC) and Dar AlArkan - have been rated. According to Standard and Poor's Rating Services, it assigned its "A+" local currency senior unsecured debt rating to the SABIC Sukuk III maturing in 2028. This at a time when only a third of global Sukuk issued were rated. S&P's stressed that "according to our criteria, we equalized the issue rating with that of the corporate credit rating on the issuer, (SABIC; A+/Stable/A-1)". S&P explained that the basis for its SABIC Sukuk III rating rested on "considering that the Sukuk holders benefit from diversification in cash flow streams, strong brand recognition, and significant cash holdings at SABIC, and therefore equalize the Sukuk rating with that on SABIC" (Damak and Volland, 2009).

Small-and-medium-sizes-enterprises (SMEs) in Saudi Arabia cannot bear the high cost of the international rating agencies, because they need to decrease their borrowing cost and therefore, it is recommended that the private sector takes the initiative and establishes local rating agencies in partnership with the global rating agencies for the purpose of adopting their rating models. This strategic step is necessary to reduce the costs of rating

for local SMEs and to assure investors of the creditworthiness of the Sukuk instruments and their originators.

Sukuk are the most attractive form of financing in Saudi Arabia compared to Shariah-compliant banking facilities or conventional bonds because they are liquid due to the fact that they are securitized and tradable. Other forms of Shariah-compliant financing such as Ijarah, Mudaraba, Murabaha and others are illiquid because money is committed for a long-term and cannot be transferred or traded.

On the one hand, investors like Sukuk because they are tradable and can be sold in the market to obtain liquidity, so they are willing to invest at a lower rate. On the other hand, Sukuk issuers like them because they can raise funds for a long tenor with favourable terms at a lower cost over time. Even though Sukuk issuers pay high fees up front for structuring, legal and arrangement fees, the cost will be lower during the entire duration of the Sukuk because the payment is at a lower rate. Sukuk must focus on risk-adjusted returns rather than absolute returns, and use risk-adjusted returns based on capital structure as opposed to allocated capital for different business lines or investment transactions.

Saudi Arabia, as the birthplace for Islam is known to have the necessary sophistication, and the human and material resources of Islamic Jurisprudence (Fiqh Al-Muamalat), to develop a unified and universally acceptable Sukuk structure based on consensus among all different Muslim schools of jurisprudence which would achieve a greater and wider acceptance of Islamic financing instruments and Sukuk implementation (Wilson, 2004).

Redefining the possibilities for corporate Sukuk in Saudi Arabia could unlock huge constructive capability of the private and public sectors alike. This could only happen if a flexible regulatory architecture for Islamic finance, especially for Sukuk structures and trusts, was developed by the relevant government agencies such as the Capital Market Authority (CMA), the securities regulator, in association with the Saudi Arabian Monetary Agency (SAMA), the central bank.

Chapter Three

Financial Markets in Saudi Arabia

Introduction

The Saudi Arabian economy has been experiencing a rapid growth in recent years fuelled by rising oil revenues due to high oil prices. Saudi Arabia owns a quarter of the proven world oil reserves. However, Saudi real GDP growth was 0.6 percent in 2009 compared with 4.4 percent for 2008 underpinned by record high oil prices in the latter year. Not surprisingly, the commodity and consumption base of the Saudi economy is subject to the volatility of the Kingdom's main source of income which is oil (SAMA Report, 2010).

This over-reliance on oil is seen to be a weakness as it keeps Saudi Arabia's economic growth subject to an excessive exposure to unstable global commodity prices. Thus economic diversification away from oil; high unemployment and rising inflation rates are the main challenges for the Saudi economy. With the proactive support of the government, the private sector has been expanding and improving its activities which are reflected on the financial markets, business confidence and increasing demand for financing since 2009. As a result, investors from all sectors are feeding their investments into the capital market with preference for Sukuk due to its liquidity because it is tradable (AlJazeeraCapital, 2010).

The strategic national economic objective of the Saudi Arabian government is to diversify the economy away from dependency on the hydrocarbon sector into other sectors such as investment and financial services and non-oil manufacturing. The Saudi capital market is increasingly performing an important function in financial intermediation to create channels of investments. With the supportive and prudent regulatory environment provided by SAMA for the banking industry, the Saudi financial industry has been flourishing for the last few decades and has managed to relatively avoid many of the crises hitting the global financial industry. This is partly due to the cautious

regulatory regime instituted by SAMA and partly because of the adoption of cautious risk management policies (Lovatt, 2008).

The Saudi Capital Market Authority (CMA) has also been a tireless reformer leading a comprehensive structural and regulatory reform program for the capital market. This program has enabled many private companies to go public in a spate of Initial Public Offerings (IPOs), which is expanding the depth and critical mass of the capital market in the Kingdom substantially. However, developing the capital market and Sukuk in particular is becoming a strategic option for the government of Saudi Arabia. Yet, the debt market is heavily exposed to the local financial markets performance. Hence, researching the financial markets is a critical part of this research.

The private sector in the Seventies and Eighties was substantially underdeveloped and the public sector represented by government ministries had no choice but to take the initiative in developing and promoting the Saudi economy and its financial sector. Saudi Arabia invested billions locally to encourage local and foreign investors to participate in establishing the biggest economy and financial sector in the Middle East. However, as a commodity-based economy, the Saudi financial market has been largely exposed to the volatility of oil prices which creates a major challenge for the Saudi financial market's economic stability and growth.

Saudi Arabia embarked on the modernization process of its financial system and market over the last few decades to enable it to play a major role in the development of the Saudi economy. As a result, The Saudi Cabinet approved the creation of The Saudi Stock Exchange (Tadawul) Company in March 2007 as a joint stock company fully owned by the government investment arm, The Public Investment Fund. Tadawul is responsible for operating the market efficiently and developing a leading financial exchange by supporting competitiveness, investment and financing channels (Tadawul Report, 2007).

The Saudi financial system was designed to have the capacity to evolve and integrate with the global financial system. For example, the Payment Instalment Law was

approved in 2005 in the midst of collective measures to reform the capital market so as to boost its ranking in the global financial markets (SAMA, 2006). One of the most important roles for the CMA was to initiate, as a strategic objective for the government, the privatization of major public facilities and services to facilitate greater participation in the growing economy, to promote a competitive environment that would maximize efficiency and minimize government wastefulness. SAMA was in charge of listing companies interested in IPOs before the establishment of CMA. Furthermore, one of the main reasons for the severe boom and bust cycles of the stock market from 2003 to 2007 was the limited quality of shares offered in the equity market (Thornton, 2008).

Saudi Arabian Money Markets

The term money market is basically defined as the trade in short-term and low-risk securities, such as Certificates of Deposit and Treasury Notes. However, in Saudi Arabia, money market operations in recent years have been narrowed down to short term treasury notes, bank deposits, repos (repurchase contracts), and foreign exchange swaps.

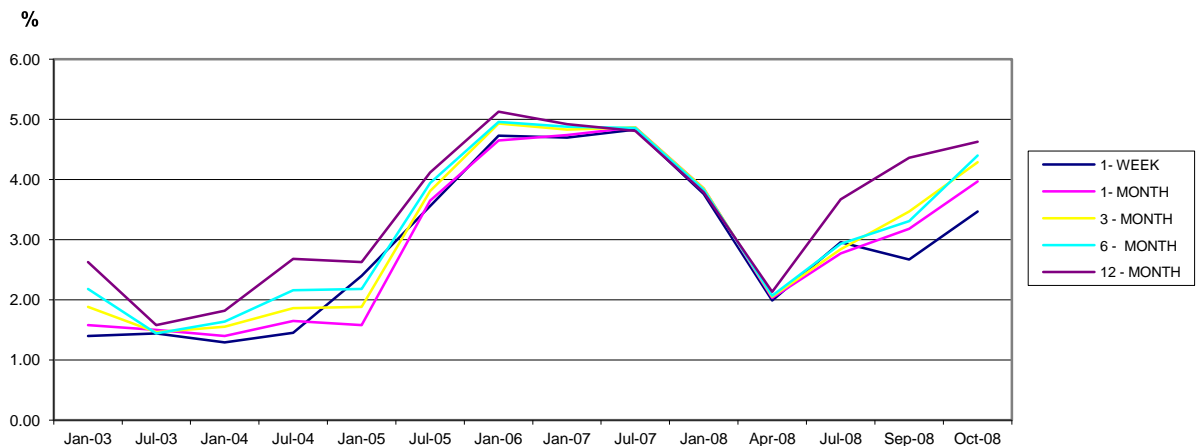
These fixed income and money market instruments have been largely traded by the Treasuries of Saudi banks to manage their asset-liability portfolio on a day to day basis and to trade in these instruments for booking trading profits. For local fixed income and money market instruments, the interest rate in Saudi Arabia is gauged by the Saudi Inter-Bank Offered Rate (SIBOR) as shown in Figure 3.1. Treasury operations and the securities investment industry have been conducted under the commercial banking industry regulations due to the absence of private investment banking institutions.

Since the inauguration of bank-guaranteed commercial papers in 2000, it has been gaining momentum within the Saudi banking industry. Furthermore, the Saudi banks have come a long way in terms of evolving more diversified portfolios of assets-liabilities in the 1990s. For example, even though banks are not obligated to invest in government debt securities, in 1996, 30% of banks assets were in the form of government securities. Aggregate loans of total assets decreased 5%, investment rose 14% and inter-bank deposits declined 11% (Dr. Al-Jasser & Banafe, 2005).

According to Dr. Al-Jasser and Banafe, Saudi banks have their own unique manner of operating where they incline to “run unhedged interest rate exposures as most of their investment of government securities are booked in investment accounts, which are market to cost”. What is more, only trading account portfolios are hedged via US dollar future market swaps to limit Saudi riyal hedging instruments.

For the most part derivatives are interest rate and foreign exchange contracts. Financial derivatives are levelling off and by the end of 2009 the value of derivatives decreased by 16.9 percent from SAR815.8 billion in 2008 to SAR678 billion. Derivatives were mostly accounted for by interest rates and foreign exchange contracts. However, many Saudi banks have been developing their Treasury operations at a cautious pace in an attempt to provide highly complex instruments to their sophisticated clients but SAMA has shown itself unfavourable to this path by implementing strict regulation on banks who engage in heavy derivative trading due to their high risk profile (SAMA, 2010).

Figure 3.1 Average SR money market rates based on daily bid rates



Source: (SAMA, 2008)

Saudi Arabian Money Market Repos

SAMA has been successful in employing SGDBs (Saudi Government Development Bonds), Floating Rate Notes (FRNs) and Treasury Bills for managing the money market in line with the US Fed since pegging the Saudi official currency, the Riyal, to the dollar in 1986. SAMA manages bank reserves by engaging in short-dated repurchase (repo)

agreements (mostly overnight repos) with banks. The purpose is to inject reserves for a regular withdrawal when repos mature to strengthen banks in order to facilitate liquidity for the private sector. As most of Saudi Arabia's exports in addition to its sovereign reserve assets are in dollars, interest rates, fixed exchange rates and the currency policy are essential issues of monetary and fiscal sovereignty to stimulate growth and attract Foreign Direct Investments (FDI) (Ramady, 2005).

Yet, some would argue that this is a double-edged sword due to the fact that when the dollar is weak, the inflationary pressure raises the cost of food and commodity imports and devalues wages of local and foreign workers due to the fact that riyal is pegged to the dollar. However, for the last couple of decades it has demonstrated that it is a temporary economic cycle and it is compensated by an increasing demand for Saudi oil by global consumers especially from the high-growth economies of East Asia. When the dollar is strong, Saudi exports especially oil, gas and petrochemicals increase in value and this limits the Saudi export competitiveness in global markets; however it does ease inflationary pressure on the cost of food and commodity imports.

SAMA's monetary strategy has been proven to be successful in dealing with the market liquidity over the last two decades. When there is a temporary need to absorb, rather than provide liquidity, bank reserves, and to balance inflation, SAMA engages in overnight reverse repos with banks (SAMA Annual Report, 2007). This roundabout mechanism by SAMA is favoured for liquidity management via reverse repo rate which steers deposit rates for lending to the private sector (Samba Economic Monitor, 2008).

The Saudi financial market functions on an open market basis with a pragmatic interest rate system. The conduct of the Saudi monetary policy influences the quantity of inter-bank liquidity through the repo window and consequently impacts the interest rate in the short-term money market as shown in Figure 3.2 - "Capital expenditure and corporate borrowing for investment reacts to banks' commercial lending rates" (Dr. Al-Jasser & Banafe, 2005).

The interest rate in Saudi Arabia as set by the Saudi Inter-bank Offered Rate (SIBOR) is affected by two factors. Firstly, as Saudi Arabia is an open economy, there are no restrictions on currency exchange. Secondly, Saudi Arabia has utilised a Riyal/Dollar pegged currency exchange rate scheme since 1986 at USD 1 = SR3.75 as it plays a decisive role in monetary policy, inflation stability and the balance of payments. The consequences of such pegging imply that Saudi Arabia's financial market is highly integrated, although not always, with the US market. Therefore, the concentrations of foreign exchange outflow and US dollar/riyal interest rates differentials (of about 1½ percent) have some affect in shaping the Riyal interest rates (USA International Business Publications, 2005).

For monetary policy objectives, like the effect on Saudi Arabia's foreign exchange reserves, this practice has benefits compared with a guaranteed acquisition of financial securities which may be subject to being reversible at short notice. The repo transactions process does not affect the prices in the bond market but merely standardizes the money market rates (SAMA Annual Report 2007). The Riyal peg to the dollar offers some macroeconomic stability which offsets its role in short-term inflationary pressures, which however remains a major challenge to the Kingdom's monetary policy. This would facilitate greater economic integration within the six countries of the Gulf Cooperation Council (GCC) for a common currency launch based on dollar reserves. In fact, the Saudi capital Riyadh has recently been chosen to be the host of the group's regional central bank.

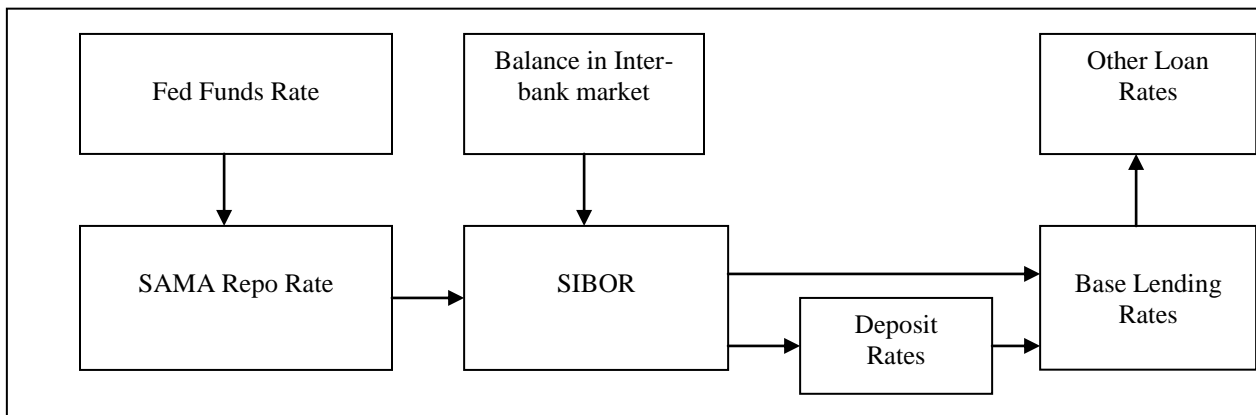
However, any comparisons of the economic conditions in Saudi Arabia and the US are fraught with problems. For example, in 2007-2008 the American economy started to slow down and in 2008 entered into a recession due to the credit crunch and housing downturn forcing the Federal Reserve to lower its interest rates substantially (The Economist, 2008). In contrast, the Saudi economy was at the same experiencing a boom due to record oil prices of \$147 pb. This surge in oil prices boosted liquidity to an unprecedented rate in the Saudi economy. However, inflationary pressure almost doubled its rate in 2008 driven by soaring local real estate rents and global food prices. As the riyal is effectively

pegged to a low and declining dollar, these factors forced the Saudi government to raise public sector wages and increase food subsidies to ease consumer prices (Bourland, 2008).

In addition, SAMA cut its reverse repurchase rate instead of the repurchase rate as it trails the Federal Reserve monetary policy, however, it started to curb inflation by tightening monetary lending to banks by requiring banks to raise their reserve requirements by up to 13.5%. That was the fourth increase in less than a year up from 7%, including for the first time in years increasing the reserve requirements of banks to cover time and savings deposits to 4% up from 2% (Karam, Reuters, 2008).

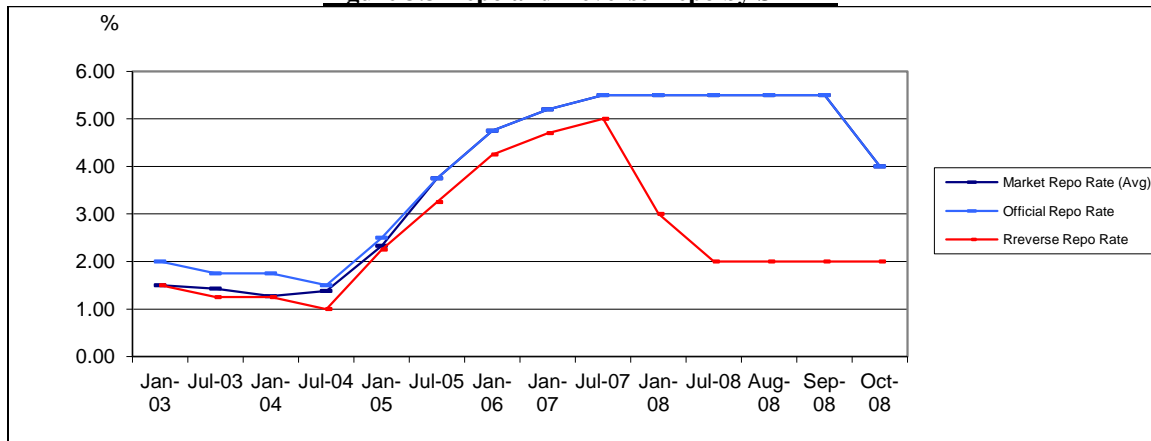
The Repos pricing mechanism is mainly priced as compatible with short dated money market rates and reverse repos carry a spread of 0.5% below the repo rate as demonstrated in figure 3.3. Moreover, SAMA has kept the repo window always open to domestic banks to elevate liquidity by way of repos to meet unexpected clearing shortages and to temporarily facilitate their secondary market making operations. SAMA has been firm in not allowing banks to buy dollars from SAMA out of the repo profits, nor permitting them to use repos to finance assets as part of their asset/liability management. In spite of this, SAMA has been lenient in terms of allowing temporary funding at the time of banks settlement (Dr. Al-Jasser & Banafe, 2005).

Figure 3.2 Inter-relationship of various interest rates



Source: Dr. AlJasser & Banafe (2005)

Figure 3.3 Repo and Reverse Repo by SAMA



Source: (SAMA Annual Report, 2008)

In 2005, the Saudi cabinet approved the establishment of a secondary market for government bonds. The purpose of establishing this market is to activate and increase the volume and depth of liquidity for diversified investment instruments with better risk management.

This has also helped lay firm foundations for the launching of a corporate bonds market offering more financing options for companies so increasing prospects for more financial leverage to expand their activities in the Saudi economy. In addition, the primary bond market was under continuous development by branching out of public debt instruments. SAMA, in partnership with the CMA, manage the future trading of government bonds by means of the Tadawul system with the possibility of offering government bonds through primary traders as bonds market traders.

In 2006 and 2007, the Saudi economy and the money supply continued to increase, which compelled SAMA to squeeze its monetary policy to contain inflation. That is why SAMA raised the official repo rate and reverse repo rate several times. Consequently, SAMA's prudent monetary policy pumped some confidence into the economy pushing the interest rate on Saudi riyal deposits to decline to levels lower than the interest rate on the US dollar deposits (SAMA Annual Report 2007).

Saudi Arabian Government Debt Securities

When the oil prices started declining steeply in the Eighties, the Saudi Arabian government revenues began decreasing significantly causing a major fiscal budget deficit. Between 1993 to 1998 the budget deficit was financed by state reserves which was built up by revenues of booming oil prices back in the Seventies. Ever since 1998, SAMA had to offer debt securities as illustrated on table 3.1 on behalf of the Saudi Ministry of Finance for the objective of deficit financing and capital market development. In the 1990s, Saudi Arabia funded its massive twin budget deficits primarily by conventional government bonds known as Saudi Government Development Bonds (Wilson, Al-Salamah, Malik and Al-Rajhi, 2004).

Nonetheless, the Saudi authorities made the strategic choice to finance the acute budget deficits in the late 1980s with domestic funds in an attempt to advance the local capital market and dynamically utilize internal coffers.

The Saudi Government debt securities were introduced in the form of Saudi Riyal denomination via two classifications. The first category was offered for retail buyers with minimum purchase of SAR 50,000. The second category was for SAR1,000,000 for financial institutions with the option of a repo agreement with the debt manager (the Saudi Arabian Monetary Agency, SAMA) for up to 75% of their total holdings. (Dr. Al-Jasser & Banafe, 2005)

Saudi Government Development Bonds (SGDBs)

SGDBs have been issued and tendered by SAMA since 1988 with fixed coupons payable semi-annually for borrowing to raise funds to finance the country's mega-projects. SAMA's debt securities distribution mechanism was via Autonomous Government Institutions (AGIs) with different maturities and coupon yields limited to the local market targeting different independent government agencies and financial institutions. Most of the Saudi debt market is predominantly comprised of government debt invested by Saudi banks as illustrated on table 3.2 and figure 3.3.

Dr. Al-Jasser and Banafe (2005) contend that SGDBs became very popular fixed income instruments as they are being offered every month in two-, five-, seven-, and 10-year maturities for financial institutions as illustrated in figure 3.4 to protect their profits versus a decline in short-term interest rates, balancing assets to their loan portfolio, and as a means of meeting the liquid reserve requirements. Between 1988 and 1998, SGDBs pricing was based on US Treasuries, and since 1998, they were priced off the one-year Riyadh Inter-bank Bid Rate (SIBID) echoing domestic money market conditions. In 2000, SGDBs pricing was changed to US Dollar interest rate swaps plus a spread as a substitute.

At the same time the Saudi bond market has reached a major landmark with the launching of a primary dealership system for government securities in the Saudi Stock Exchange (Tadawul) Company. This new system could transform the mechanism of debt securities pricing from the current SAMA system, used for its own repurchase facility pricing, by initiating a professional pricing and access to these facilities linked to market-making obligation in the secondary market.

Similarly, the Saudi debt market desperately needs to liberalize trading to activate measures authorizing principal dealers to buy on margin while giving the same existing trading rights to non-bank dealers. This reform process would unchain the projections for demand of government and non-government securities (IMF Country Report, 2006).

Saudi Arabia's corporate bond market is still in its infancy relative to the western corporate bond markets. Almost all public debt is held by government-linked agencies and financial institutions. SGDBs are also open for foreign investment. The bond market has a long way to go in terms of creating depth and critical mass of issues and trading. However, the bond market does help SAMA policy instruments in the shape of open market operations. SAMA can influence credit control according to its own judgment by changing the liquidity status of banks by trading directly in the market and changing the costs of its credit. (Dr. Al-Jasser & Banafe, 2005)

The impact of soaring oil prices has helped the Saudi Gross Domestic Products (GDP) to recover enabling the Saudi government to reduce the issuance of quarterly Saudi Government Development Bonds (SGDBs) from SR 5 billion in 2005 to SR 1.5 billion in 2006 (SAMA Annual Report, 2007).

Treasury Bills

As a form of short term debt securities, Treasury Bills are used for cash-flow management offered only to banks. In 1991, another cornerstone evolution took place in the Saudi capital market where Treasury Bills have taken the place of Bankers Security Deposit Accounts (BSDAs-i.e. Central Banks Bills) being offered on weekly basis for quarterly fixing linked to 3-month SIBOR for maturities of 1, 4, 13, 26, and 52 weeks (SAMA Annual Report 2007).

Due to the fact that the Saudi government fiscal situation improved considerably in 2005 and 2006 as oil prices surged, the Saudi government diminished its recourse to a weekly issue of Treasury Bills from SR 2 billion in 2005 to SR 1 billion in 2006. The Saudi Gross Domestic Products (GDP) strengthened at an unprecedented rate which helped to bring down the public debt from 82 percent in 2003 to 65 percent in 2004, to 38.9 percent in 2005, and 27.9 percent in 2006 (SAMA Annual Report 2007). Treasury Bills (t-bills) have been an efficient scheme in the liquidity management currently implemented by SAMA.

Floating Rate Notes (FRNs)

As a medium-term note, Floating Rates Notes (FRNs) gave semi-annual returns as measured on every business day in Saudi Arabia since their issuance by SAMA in 1996 with a different mechanism for each kind of fixed income instrument. Also, the tenor varied in an attempt to provide new fixed income investment instruments in a nascent and rapidly developing capital market. In 2006, the Saudi government reached a relatively prosperous financial situation because of extraordinary high oil prices proceeds leading the Saudi Gross Domestic Products (GDP) to grow sharply. For this reason the Saudi government ceased issuing more FRNs (SAMA Annual Report 2007).

Table 3.1 SAMA: Current securities offerings

Security Issue	Currency Denomination	Tenor	Pricing	Offering	Observation
Treasury Bills (T-Bills)	SR	1,4,13, 26 & 52 Weeks	Saudi Riyal Interbank BID rate	Weekly basis	Replaced the 180 days Bankers Special Deposit Accounts
Floating Rate Notes (FRNs)	SR	5 & 7 year maturities	Saudi Interbank Offer Rate (SIBOR) Plus Margin	Monthly basis	Introduced in 1996 to provide rate risk hedging
Government Development Bonds (GDBs)	SR	2, 3, 5, 7, and 10 year maturities	Priced to reflect relative value in alternative investments (US Bonds) plus 25-75 basis points premium	Quarterly basis	Issued on a fortnightly basis until 1996

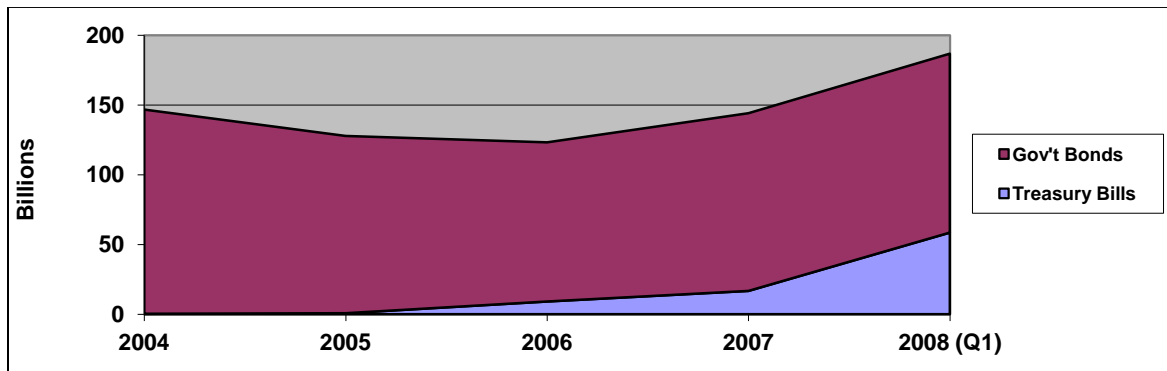
Source: (SAMA Annual Report, 2007)

Table 3.2 Commercial Bank's Investments in Government Securities

	2004		2005		2006		2007		2008 Q1	
	Value (SR B)	Change (%)	Value (SR B)	Change (%)	Value (SR B)	Change (%)	Value (SR B)	Change (%)	Value (SR B)	Change (%)
Treasury Bills	0.3	52.5	0.7	168.3	9.1	1177.5	16.7	84.0	58.5	249.1
Gov't Bonds	146.4	-2.8	127.1	-13.2	114.1	-10.2	127.4	11.7	128.3	0.7
TOTAL	146.7	-2.7	127.8	-12.9	123.3	-3.6	144.2	16.9	186.8	29.6

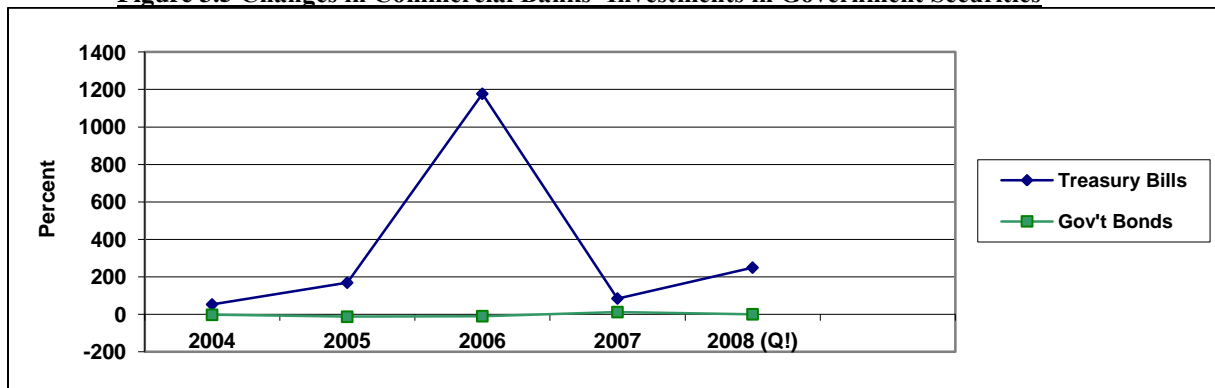
Source: (SAMA Annual Report, 2007)

Figure 3.4 Commercial Bank's Investment in Government Securities



Source: (SAMA Annual Report, 2007)

Figure 3.5 Changes in Commercial Banks' Investments in Government Securities



Source: (SAMA Annual Report, 2007)

The Saudi sovereign debt owed to local institutions peaked at 119 percent of GDP in the late 1990s by issuing sovereign debt instruments like GDBs, Treasury Bills and FRNs. However, the secondary debt market remains inactive due to the fact that these are mainly bought by autonomous government agencies and some banks on the basis of hold-to-maturity. It is imperative to create an efficient secondary market for the purpose of increasing the issuance of new corporate debt instruments such as corporate Sukuk and bonds. A liquid secondary debt market will facilitate the creation of a mechanism for the redemption payments of the movements of bond pricing. SAMA's role is in improving issuance mechanisms, like tap issues; to create size - a full maturity spectrum for duration management, fixed and floating coupons to diversify prices risk, and the availability of a repo facility for day-to-day liquidity management (Malik, AMEINFO, 2006).

SAMA has been also proactive in revitalizing a distribution network in cooperation with other government agencies like the CMA and Tadawul from one side and banks from the other side for a dealership system and promoting underwriting and distribution obligations especially with banks. However, limited investor demand, low level of awareness and previously lack of investment banks are the major obstacles to activating secondary market trading. Establishing an active secondary market requires the adoption of a package of measures and campaigns in many areas in order to promote corporate Sukuk and bonds including but not limited to expanding the series and distribution of government instruments.

Saudi Arabian Stock Market

The Saudi Arabian stock market was established in 1985, regulated and supervised by the SAMA. In 1998 the total market capitalization was SAR 159.9 billion as illustrated on table 3.3 dominated by banking companies in terms of value and number of banks who were most actively traded in the market (Tadawul, 2007). From 1985 to 2003, the market was under the regulation and supervision of SAMA which restricted trading to Saudis only. As a regulator of the stock market during that period SAMA had been supportive of bank listings after their partnership with a major global bank for wider local shareholding

base, better corporate governance and transparency. This has helped in creating a solid banking and investment industry easier to supervise and monitor by regulators. (Moody's, 2008)

Saudi authorities decided to initiate a comprehensive economic expansion to diversify the national economic resources. Hence, they launched different restructuring initiatives for many industries including the capital market industry starting with the foremost financial pillars for the biggest bourse in the Middle East. Since establishing the CMA, and the steep surge in oil prices since 2003, the Saudi stock market had enjoyed a vigorous and sharp increase represented by the Saudi Tadawul All Share Index (TASI) which reached record levels until 2006 (The Economist 2007)

The Saudi stock market experienced high levels of investor confidence from 2003 buoyed by the improving state investment environment, steady economic progress, a contained inflation rate and booming profits of public companies. All of this propelled TASI to reach record levels, rising exponentially, and showing the spectacular gain from 2,500 points in January 2003 to 20,634 points in February 2006 as shown in figure 3.5. Tadawul registered its record peak with the total value of shares traded at a peak of SAR5.26 trillion (US\$1.40 trillion). However, from 2006 to 2009 the Saudi equity market experienced a sharp correction forcing it to decline sharply as shown by its worst performance for years. Many Saudi individuals and institutional investors suffered badly as a result of this correction (Tadawul, 2009).

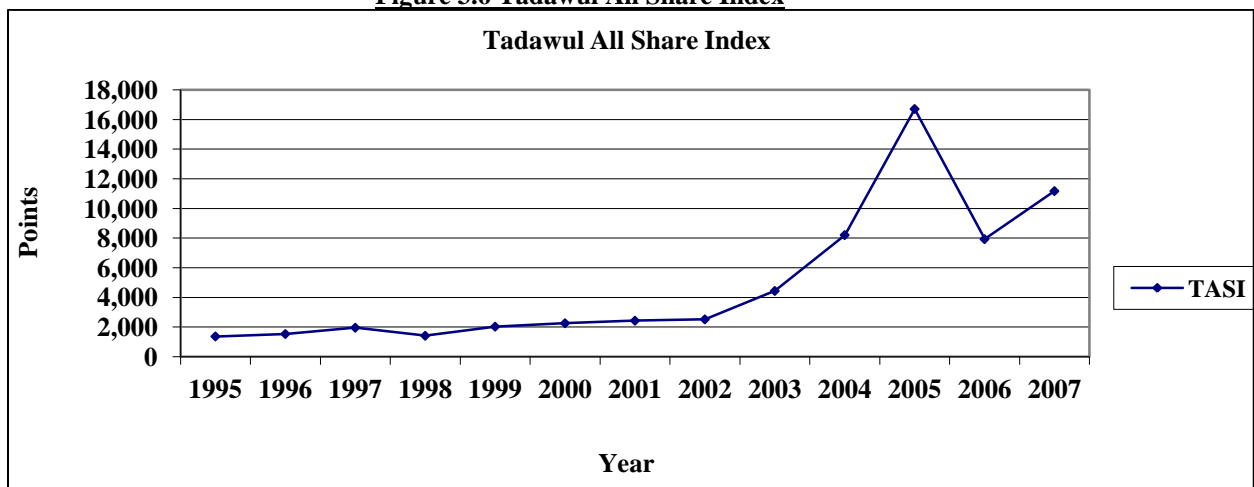
The CMA initiated several courses of actions including splitting the nominal value of all listed companies' shares into SR10 per share instead of SR50, and allowing resident expatriates to invest directly on the stock exchange in 2007. The CMA also allowed foreign non-resident investors to invest directly via swap agreements through financial institutions in 2008 and thus to invest directly in the local equity market. Unfortunately, these measures were too little and too late for a market that has been losing local confidence due to several factors, including organized speculation and manipulation of the market which dented confidence. Overvaluation of shares, especially of small firms

and the few new small insurance companies was rife. The shares of these small insurance companies were offered at an IPO at a nominal price of SAR10 per share, which increased to over one thousand times over their nominal value from the first day of trading for companies who had not even started business yet. (SAMA Report 2007, pp78) (Woertz, 2006)

The equity market continued its slide even while oil prices reached the record level of \$147pb n 2008. This was due to the lack of corporate governance, institutional investors who count for less than 10% of the stock market investors, in an environment of insufficient independent research and analysis. Due to the unique structure of the Saudi equity market, until 2008-2009 commercial banks were the only institutions providing financial and investment services (Wigglesworth, FT, 2010).

This created a situation of conflict of interest where commercial banks that provide equity trading facilities were at the same time also providing financing facilities and loans to the same listed companies. Moreover, commercial banks were not in a position to provide or publish a professional analysis to the same companies to whom they provided financial services, in fear of losing their business. These shortcomings and flaws in the investment system have been affecting investors' decisions negatively regarding the companies they invest in.

Figure 3.6 Tadawul All Share Index



Source: (Tadawul Annual Report, 2007)

Table 3.3 Market Capitalization & Tadawul All Share Index (TASI) 1995-2007

Year	Market Capitalization (SR billion)	Change (%)	TASI	Change (%)
1995	153.39		1367.60	
1996	171.98	12.12%	1531.00	11.95%
1997	222.70	29.49%	1957.80	27.88%
1998	159.91	-28.19%	1413.10	-27.82%
1999	228.59	42.95%	2028.53	43.55%
2000	254.46	11.32%	2258.29	11.33%
2001	274.53	7.89%	2430.11	7.61%
2002	280.73	2.26%	2518.08	3.62%
2003	589.93	110.14%	4437.58	76.23%
2004	1148.60	94.70%	8206.23	84.93%
2005	2438.20	112.28%	16712.64	103.66%
2006	1225.86	-49.72%	7933.29	-52.53%
2007	1946.35	58.77%	11175.96	40.87%

Source: (Tadawul, 2007)

The CMA has since then issued a significant series of rules and regulations covering corporate governance, mutual funds, and Real Estate Investment Trusts (REITs). In addition, the CMA issued licenses for many investment companies for the following main investment activities: dealing, managing, custody, arranging, and advisory. The CMA also paved the way for many new and old private sector companies to offer parts of their shares to the public via IPOs within different sectors on the Tadawul Stock Exchange. In the last few years, numerous family businesses and privatized government-owned entities and companies offered millions of shares for public subscription. This was one of the main factors behind the convergence of a significant portion of the public into the Saudi equity market with limited background amidst the non-existence of an independent equity research sector separate from retail banks that have major business relationship with expected IPO companies (AlGhazzawi and Brimson, 2010).

Prior to the CMA, listing requirements involved a lengthy and costly process handled by the many government agencies like SAMA, the Ministry of Commerce & Industry and a number of other agencies. The CMA strove to improve the depth and breadth of the

equity market by listing more companies than the already 60 listed companies up to 2003. Consequently, the CMA made listing more efficient in an attempt to encourage thriving businesses to list with a reasonable premium. However, in the first few years it during which it facilitated listing, the CMA found it encouraging even for non-productive and low value companies to seek listing at a high premium with a very small capital to raise funding easily, as a partial exit strategy and to fund imprudent expansion plans (Tadawul, 2007).

Furthermore, the mechanism of determining the value of the premium has been an issue subject to much questioning by the regular public investors as some of these small caps were overvalued and became the subjects of steep speculation. Most of these companies were in the retail and insurance sectors. These companies helped to create a speculative culture of IPOs with rapid profits as they are always heavily oversubscribed due to the lack of IPO valuation awareness and the poor knowledge of the public about the fundamentals of these stocks. In recent years, the CMA developed the book-building process for determining the appropriate premium value (NCB Capital, 2008).

With the limited availability of mutual funds only from banks as the sole tool for institutional equity investment, potential public investors did not have a variety of reliable options among financial investment channels. This situation has created widespread public discontent among individual investors, who represent the majority, as they helplessly saw their equity portfolios evaporate. Mutual funds as an asset class constituted 65 percent of all funds, up to the end of 2006, with 64 percent of these funds being Shariah-compliant (SAMA Annual Report, 2007).

However, it is imperative for the capital market in Saudi Arabia to diversify channels of investment away from equity and into alternative assets class such as Sukuk and bonds with a broad range of high quality underlying assets. Officials have already expressed interest in doing so, to ease the over-concentration on equity market portfolios for individual and institutional investors. The strategy of introducing many new asset classes to the market, which is being adopted by regulators, would add great weight and value to

both the business environment and investors in general. This initiative would have a selection of risk management tools and to activate the secondary market for these asset classes. This is an effective plan to deepen the market and minimize the severity of boom and bust cycles. (Moody's, 2008 Special Comment)

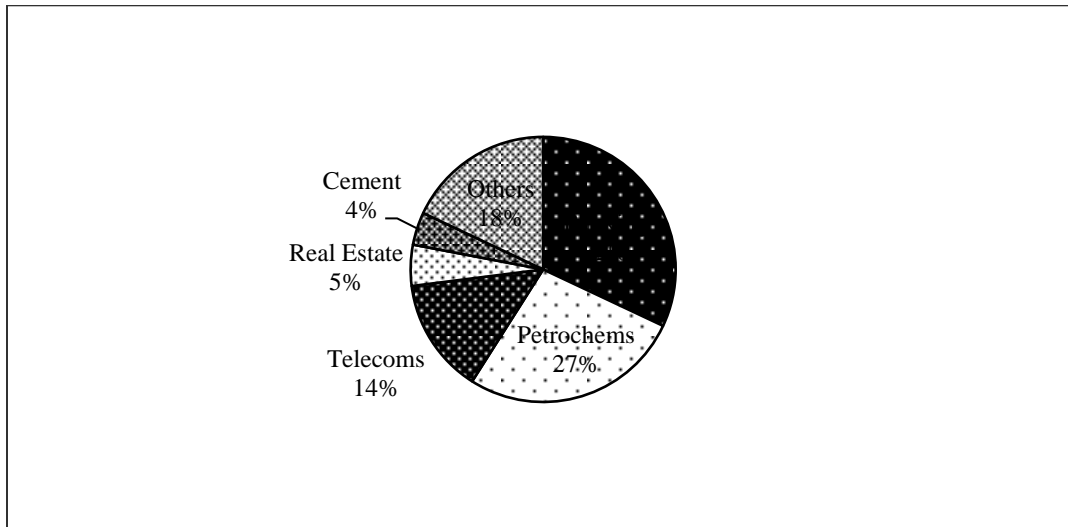
**Table 3.4: Specialized Credit Institutions and the Annual Report
on the Performance of the Saudi Capital Market**

	2005	2006	Annual Change %	2007	Annual Change %
General share price index (1985=1000)	16,712.6	7,933.3	-52.5	11,176	40.9
Assets of investment funds (Billion Riyals)	137.0	84.2	-38.5	105.1	25
Commercial banks' investments in Government Securities (Billion Riyals)	127.8	123.3	-3.6	144.2	16.9
Bank credit (Billion Riyals)	452.5	497.1	9.8	594.8	19.7
Loans disbursed by specialized credit institutions (Billion Riyals) (During the period)	8.7	10.2	16.9	16.5	62.0

Source: (Tadawul and SAMA Report, 2007).

The Saudi stock market fell steeply by more than 26 percent of its value in October 2008 triggered by the global financial crisis, although it fell by an alarming 52.5 percent and 40.9 percent in 2006 and 2007 respectively as shown in table 3.4. The Saudi stock market has been exposed to a downturn in the global equity market, a global credit crunch and falling oil prices with severe negative pressure (Samba Economic Monitor Dec. 2008). The banking sector is the biggest sector by market capitalization, as illustrated on figure 3.6, followed by the petrochemical sector, which is still more exposed to the global economic cycles.

Figure 3.7 Market Capitalization size by Sectors as of Nov. 23, '08



Source: (SAMA Report, 2007)

Saudi Arabian Fund Management Issues

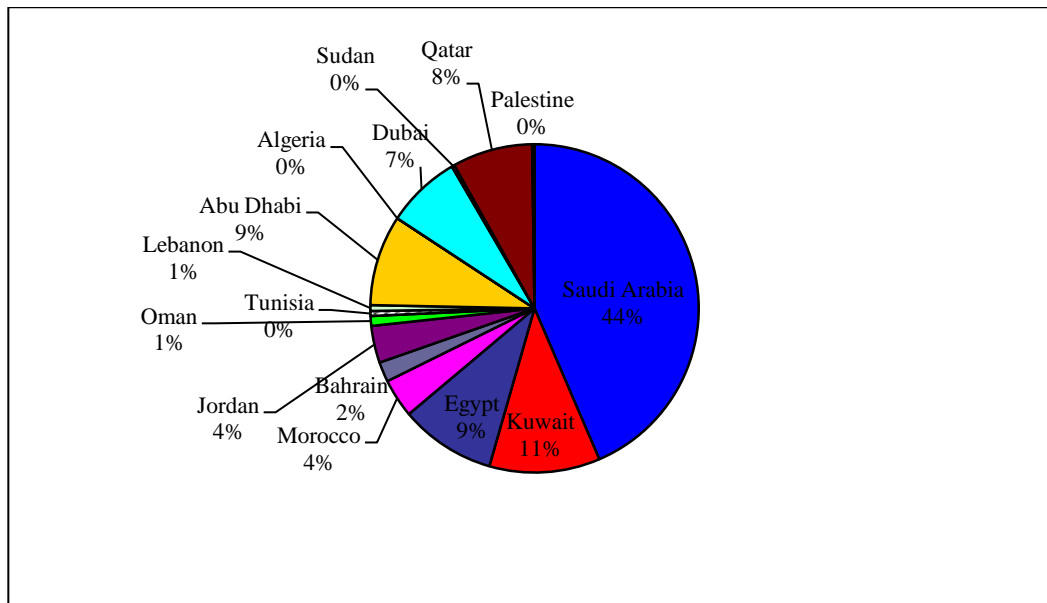
In the last decade, mutual funds all around the world have gained momentum in terms of size and subscribers and specializing in different industrial sectors. By the end of 2007, the number of US funds reached 8,029 with US\$12 trillion in total net assets and more than 21,600 numbers of share classes. Moreover, around 300 million shareholder accounts were established (a mix of individual's and omnibus accounts). In 1990, there were around 3,177 share classes and around 61,948 million shareholder accounts (a mix of individuals and omnibus accounts) (Investment Company Institute, 2008).

However, the first mutual fund in Saudi Arabia was developed by National Commercial Bank (NCB) in 1979 as a short term dollar fund for small investors. Furthermore, prior to the CMA's creation in 2003, only commercial banks were allowed to develop funds.

Mutual funds have since then grown considerably in terms of number and size, and due to the licensing of more independent investment institutions. Moreover, collective investment schemes of mutual funds have come under rising demand during the 2003-2006 Saudi equity boom. However, the weight of mutual funds in the equity market did not exceed 10 percent of the total market capitalization (Arabian Business, 2006).

Even though Saudi Arabia is the biggest capital market in the MENA region by Market Capitalization as illustrated on figure 3.7 for 2006, the Saudi stock market has remained relatively small since its creation in 1985. It was also closed to non-Saudis so that only Saudis could buy and sell shares in the stock market. SAMA, the regulator of the Saudi stock market until the CMA creation in 2003, in early 1997 gave permission to the Saudi-American Bank (now known as Samba Financial Group) to establish a closed end mutual fund of Saudi stocks for foreigners. The fund, named the Saudi Arabia Investment Fund (SAIF), is dollar-based and sold through the London Stock Exchange (Ramady, 2005).

Figure 3.8 Percentage Share of Arab Capital Markets as End of 2006 by Market Capitalization



Source: (Tadawul, 2007)

Before the establishment of the CMA, SAMA was in charge of the licensing of mutual funds. Mutual funds in the 1980s and 1990s showed little signs of growth because they

were limited in number and size, and with assets of merely around SAR 13 billion. In 1994 there were only 61 mutual funds with 30,945 subscribers/shareholders and total assets of SR12 billion (Zahid, 2005). Between 1997 and 2004 there had been a remarkable growth with 105 mutual funds and SAR 19 billion in Net Asset Value (NAV) and 60,000 subscribers. Nevertheless, the growth of mutual funds especially aimed at the domestic market spiralled in the late 1990s reaching 170 mutual funds and 172,000 subscribers by early 2004, an increase of 187 percent (Al-Suhaimi, 2003).

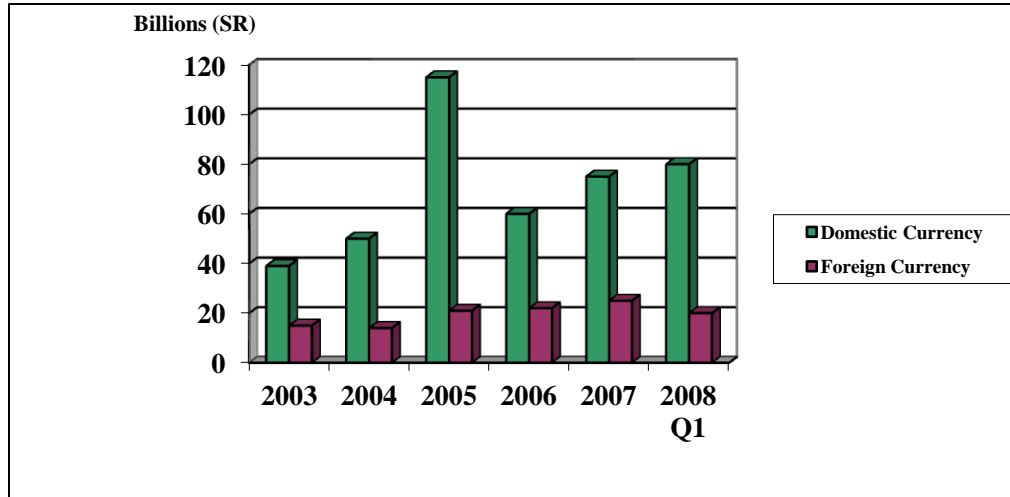
**Table 3.6 Assets of Investment Funds Managed by Domestic Commercial Banks
Distributed by type of investment**

End of Period	Domestic Shares	Foreign Shares	Domestic Bonds	Foreign Bonds	Domestic Money market instruments	Foreign money market instruments	Other domestic assets	Other foreign assets	Total Assets
1999	1,569	6,686	2,108	576	6,231	4,717	4,251	8,544	34,682
2000	1,360	7,697	7	193	7,849	2,064	7,367	12,019	38,556
2001	2,355	6,844	7	180	13,723	3,999	14,332	8,619	50,059
2002	2,437	5,339	10	122	15,516	3,398	14,864	7,140	48,826
2003	4,841	7,638	7	134	15,360	3,105	17,008	5,773	53,866
2004	14,572	8,461	27	128	10,379	2,276	19,512	4,962	60,317
2005	89,444	14,667	20	79	6,501	1,607	19,696	4,960	136,974
2006	31,960	15,583	1,683	168	23,951	3,512	3,749	3,501	84,108
2007	45,206	16,809	531	264	29,362	3,518	4,611	4,799	105,099
2008 Q1	39,918	15,168	964	208	37,128	2,819	5,126	2,639	103,971

Source: (Tadawul, 2007)

Since 2001, more local equity funds were introduced as opposed to global and country equity funds. For example, in 2000, about 57 percent of Saudi mutual fund assets were investing globally. However, in 2001 the percentage dropped to only 39 percent and plunged further to 24 percent in the Q1 of 2005 (Zahid, 2005). Mutual funds' assets under management have grown enormously from SR34.7 billion to SR138 billion between 2000 and Q1 2006 with subscribers increasing from 80,000 to over 663,000 for the same period (Hassan & Tago, 2006). By Q1 2008 mutual funds assets came down from their peak in 2005 to SR80 billion for Saudi currency funds and SR20 billion for foreign currency funds as shown in Figure 3.9.

Figure 3.9 Assets of Investment Funds at Domestic Banks



Source: (Tadawul, 2007)

Since the equity boom in 2003, various investment funds were launched by investment banks and financial institutions to capitalize on the prospering market. In the last few years, the CMA has been attempting to transform the Saudi equity market from being overwhelmingly invested by 95% individuals to a market being mainly invested by financial investment institutions through means of mutual funds. Furthermore, the boom in the equity market from 2003 to February 2006 assisted in doubling the number and size of Saudi mutual funds. For that reason, there has been an excessive demand by the public, particularly for Shariah-compliant mutual funds to benefit from the sudden surge of the equity market fuelled massively by Saudi budget surpluses, the availability of ample liquidity and increasing corporate profits.

There has been a fierce competition among banks in developing professional in-house fund managers who can provide top-tier asset management. Mutual funds are ranging from Shariah-compliant to conventional funds targeting potential individuals (expatriates and non-residents) and institutions for local investors.

These investors are interested in securing retirement by the end of their career by sharing risks via pooling their financial resources for a cost efficient method.

Mutual funds are regarded as offering a balanced risk/return investment formula in the Saudi equity market. Saudi mutual funds ranged from equity stocks to bond investment schemes, corporate ventures by means of Initial Public Offerings (IPOs) and capital issues diversified locally and globally as shown on table 3.6. Even though mutual funds in Saudi Arabia are growing substantially especially Shariah-compliant funds, their share of the capital market remains limited to less than 5% of the equity market. This is due to the lack of public awareness, low transparency and lack of asset management efficiency. The National Commercial Bank has the biggest assets under management; followed by Riyadh Bank and Saudi British Bank (now known as SABB) with a standard minimum subscription allowed for mutual funds of SR 5,000 (Zahid, 2005).

Table 3.5 Most Important Indicators of Investment Funds Operated by Domestic Banks

Year	# of Operating Funds	Annual Change (%)	Domestic Assets Investm't (Billion SR)	Annual Change (%)	Foreign Assets Investm't (Billion SR)	Annual Change (%)	Funds' total assets (Billion SR)	Annual Change (%)	# of subscribers (Thousand)	Annual Change (%)
1996	83	16.9	8.2	41.2	8.5	18.4	16.7	28.5	45.1	36.6
1997	104	25.3	11.2	37.7	10.2	20.1	21.4	28.5	63.3	40.3
1998	121	16.3	12.0	7.0	13.0	27.3	25.0	16.7	69.5	9.9
1999	134	10.7	16.0	33.1	18.7	43.8	34.7	38.7	79.3	14.1
2000	138	3.0	16.6	3.8	22.0	17.4	38.6	11.2	95.8	20.8
2001	138	0.0	30.4	83.4	19.6	-10.6	50.1	29.8	174.0	81.6
2002	143	3.6	32.8	7.9	16.0	-18.6	48.8	-2.5	165.0	-5.1
2003	170	18.9	37.2	13.4	16.7	4.4	53.9	10.5	172.2	4.3
2004	188	10.6	44.5	19.6	15.8	-4.9	60.3	11.9	198.4	15.2
2005	199	5.9	115.7	160.0	21.3	34.7	137.0	127.1	568.3	186.5
2006	214	7.5	61.3	-47.0	22.8	6.9	84.1	-38.6	500.0	-12.0
2007	252	17.8	79.9	30.2	25.2	10.7	105.1	25.0	426.1	-14.8
2008 Q1	260	20.9	79.9	40.2	21.0	-4.6	104.0	28.0	413.9	-12.9

Source: (SAMA Report, 2008)

The CMA has issued a series of rules and regulations covering transparency and protection of investors for the Mutual Funds. Additionally, SAMA and the CMA have been cooperating to increase the rate of awareness of mutual funds by launching many educational programs and awareness campaigns with the assistance of Saudi banks (Khalil Hanware, 2005). However, mutual funds, which used to be considered a major market stabilizer, were hit by a significant setback during the February 2006 equity

market bubble. Mutual funds companies were accused by retail investors of a lack of transparency and management efficiency. Consequently, mutual funds have still not recovered the trust of retail investors.

SAMA and the CMA focused on developing the mutual fund industry by emphasizing the following regulations:

- i) Requiring world-class standards of corporate governance, transparency and listing to ensure fair and full competition.
- ii) Requiring full market disclosure for well informed decisions by investors via public publications.
- iii) Requiring financial institutions to build a professional and effective infrastructure for the market place.

Tadawul's website allows investors to scrutinize mutual funds information offered by financial institutions including the latest prices, historical Net Present Value (NAV) and mini-prospectus as stated in table 3.5 to enable responsible investment decisions by investors (Al-Suhaimi 2003). Furthermore, according to Zawya Mutual Funds Monitor research, the mutual fund industry is estimated to continue to grow as it has now over 200 funds. Innovation in Shariah-compliant funds is the most important vehicle for the industry as the public is demanding more Shariah-compliant investment assets classes (Ijtehadi, 2007).

Saudi Arabian Legal and Regulatory framework for SAMA, CMA, DIFC & Central Bank of Bahrain

The macroeconomic structure of developing countries and its regulation of financial institutions are key factors in maximizing benefits and minimizing vulnerability from exposure to the dynamics of financial globalization. Both the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA) are determined to create market-based operations and to follow a soft touch regulatory approach to allow the private sector to take the lead in developing the local financial sector. The CMA in turn

has taken the responsibility of evolving corporate governance measures to protect and guarantee shareholders' rights.

Saudi Arabian Monetary Agency (SAMA)

SAMA is the central bank of the Kingdom of Saudi Arabia and was established in 1952. It has the responsibility for setting monetary policy and is designed to serve as a Shariah-compliant central bank. It has a unique organizational structure as shown in figure 3.9 designed to preserve its operational independence, based on a liberal monetary policy of free control of interest rates, foreign exchange and movement of capital (Ramady, 2005).

SAMA acts as a banker to the government with its main functions being: issuing national currency (the Saudi Riyal), supervising commercial banks, managing the Kingdom's foreign exchange reserves, conducting monetary policy for promoting price and exchange rate stability, promoting the growth and ensuring the soundness of the financial system. Another major role for SAMA was to shore up the government reserve, which has been extensively diminished, to fund the public finance deficit. Hence, SAMA has been issuing and selling Government Developments Bonds (GDBs) that have varying short- and long-term maturities and are giving yields that are competitive with international interest rates. Almost all of SAMA's GDBs were purchased by autonomous government agencies like the Public Pension Fund (PPF), the General Organization for Social Insurance (GOSI) and Saudi banks.

Tale 3.7 SAMA's monetary policy instruments: comparative analysis

Policy Instrument Tool	Rational, and Operational Usage	Effectiveness
Cash Reserve Ratio (CRR)	<ul style="list-style-type: none"> • To ensure banks have adequate liquidity to cover customer deposits. • 7% on current accounts and 2% savings/time deposits since 1980 	<ul style="list-style-type: none"> • Used for implementing structured changes in bank liquidity and for short term liquidity. • Produces strong signal effects. • Not imposed on inter-bank transactions

Statutory Liquidity Ratio (SLR)	<ul style="list-style-type: none"> • Banks are required to maintain minimum 20% liquidity assets of demand and time deposits. 	<ul style="list-style-type: none"> • “Free liquidity” at disposal of banks can influence over all bank lending structure (Short/long term)
Repo	<ul style="list-style-type: none"> • SAMA alters liquidity position of banks by dealing directly in the market to make temporary additions to banks reserves via short dated repurchase agreement (over nights) 	<ul style="list-style-type: none"> • Allows for short-term injection of reserves and automatic withdrawal upon repo maturity • Efficiency depends on SAMA’s holding of securities and size and depth of market.
Reverse Repo	<ul style="list-style-type: none"> • Need for banks to place excess liquidity with SAMA via overnight matched sale-purchased operations. 	<ul style="list-style-type: none"> • SAMA can absorb rather than provide bank reserves. • A definitive purchase of financial assets reversible at short notice not affecting prices in bond market: serves to regulate the money market.
Foreign Exchange Swaps	<ul style="list-style-type: none"> • Intention to influence capital outflows, avoiding disruptions to monetary policy from foreign exchange markets. • Used for liquidity management and currency speculation. 	<ul style="list-style-type: none"> • More flexible than repos/reverse repos in terms of their maturity and volume per deal. • Affecting liquidity but do not generally exercise influence on foreign exchange rate.
Placement of Public Funds	<ul style="list-style-type: none"> • At SAMA’s discretion to place governmental institutions’ funds with selected banks 	<ul style="list-style-type: none"> • A “rough tuning” instrument providing banks with long-term liquidity support. • Can signal crises management and problems in banks.

Source: (SAMA, Annual Report, 2003)

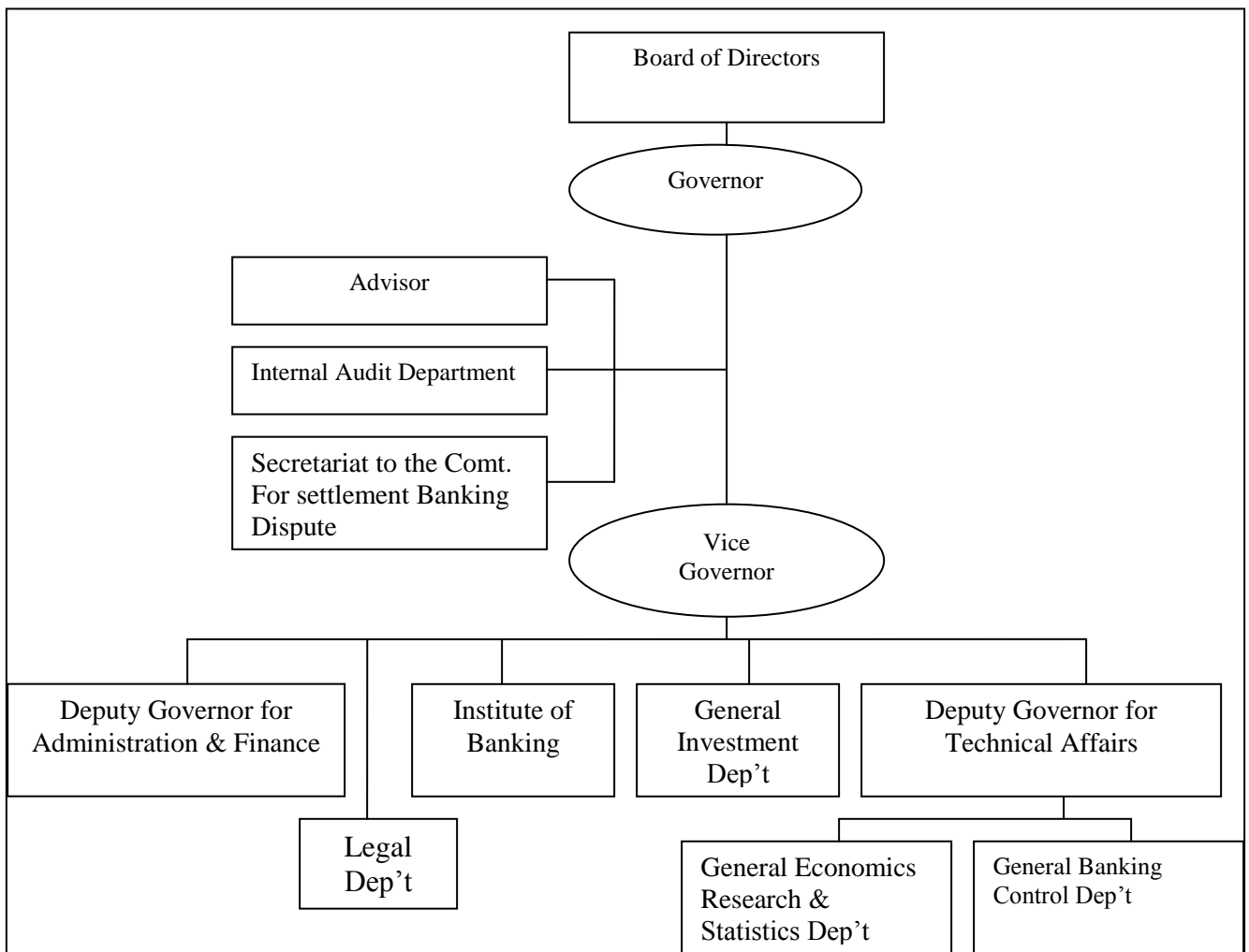
Ramady contends that SAMA has developed from being a Monetary Agency with a limited role, into a fully pledged central bank with relative independence, with a broad range of monetary tools at its disposal, and with effective supervisory powers over the financial sector. Monetary policy is the primary focus of SAMA, whose key objectives are to stabilize inflation and the general level of prices, to maintain a fixed exchange rate policy against the US dollar and to allow free movement of currency and capital. SAMA used four main policy instruments in conducting monetary policy: i) cash reserve ratio/minimum reserve policy, ii) Repos and Reserve-Repos which control the yield that commercial banks receive on their deposits with SAMA, iii) foreign exchange swaps, and iv) placement of public funds as demonstrated in table 3.7 (Ramady, 2005).

SAMA has been increasingly relying on Reserve-Repos, the “open-market operations” to align the benchmark with short-dated global market rates and to manage inflation. SAMA has been offering a broad range and mix of securities on behalf of the government, ranging from short Treasury Bills (under one year) to 10 year government development bonds, priced at a premium to similar dated US Treasuries and bonds. SAMA’s monetary policy assigns a high priority to its current fixed exchange policy as a means of controlling inflation, despite recent depreciation of the US dollar against major international currencies. Domestic money supply creation is a function of dollar reserves held abroad, domestic government spending and the effects of domestic purchases of foreign currencies for trade and remittances (Ramady, 2005).

There is evidence to suggest that the Saudi economy is going through “financial deepening” with a reduction in the level of currency ratio, and increasing monetization of long term assets. SAMA faces a number of future challenges including more effective participation in the GCC monetary union and the proposed single currency, co-developing a corporate bond market, the supervision and control of cross-border Saudi bank mergers and “new-wave” entry of foreign banks into the Saudi market, as well as overseeing the growth of Islamic finance and banking products in the Kingdom.

Although SAMA was licensed four local Islamic banks – Alrajhi Bank; Bank Al-Bilad; Alinma Bank and Bank Al-Jazira - it did not attempt to regulate the Islamic finance industry; hence SAMA adopted the wait-and-see position (Rodney Wilson, 2004). During the 2000s, the Saudi banking industry was facing a substantial demand for Shariah-compliant investment products such as Sukuk, which caused the first Sukuk offerings of Saudi Arabian Basic Industries (SABIC) and Saudi Electricity Company (SEC) in 2006, 2007, 2008, 2009 and 2010 respectively to thrive.

Figure 4.0 SAMA Organizational Chart



Source: (Ramady, 2005)

The Saudi corporate bond market is still in a nascent stage, under-developed and in critical need of improvement and restructuring, and particularly needs a regulatory

framework. The Saudi ORIX Leasing Company was the first company to offer a corporate bond issued in March 2003. However, a major limitation to origination is Article 117 of the Companies Law which states that the total amount of bonds that a company can issue may not exceed its paid up capital.

The International Monetary Fund (IMF) is recommending that financial institution and leasing companies should be exempt from this ruling to increase and diversify corporate bonds issuance. This step would decrease the cost of short-and-medium-term debt securities, such as commercial papers and/or medium term notes. The IMF contends that the availability of a wide-range of debt securities would allow the capital market to support the Saudi economy (IMF Country Report, 2006).

The Saudi Capital Market Authority (CMA)

Even though there have been plans to formalise the capital market since the early-1980s, the CMA was only established by the Capital Market Law in 2003 (Abdeen et al., 1984). The CMA is a government organization with financial, legal and administrative independence. “The CMA is an official capital market regulatory authority which operates under full financial, legal, and administrative independence, and has direct links with the Prime Minister’s office” (CMA, 2011). The CMA is governed by a board of five full time members (Chairman and four Commissioners) appointed by Royal Decree as shown in figure 3.10.

The CMA mandate is to regulate and develop the Saudi Arabian Capital Market by issuing the required rules and regulations for the implementation of the provisions of Capital Market Law aimed at developing an appropriate and transparent investment environment and to build the Capital market to be the main business and employment generator for the Saudi economy.

Prior to the creation of the CMA, the capital market was substantially underdeveloped, because the lack of listing rules kept many top companies from being traded publicly on the equity market.

The rationale for establishing the CMA was to regulate, and improve the capital market and to make it more efficient, in partnership with all businesses, for the purpose of protecting investors, shareholders and the general public from unfair and unsound practices. The aim is also to provide a solid regulatory framework including measures against fraud, deceit, cheating, manipulation and insider trading so that the capital market could be the engine of growth for the Saudi economy.

Hence, promoting corporate governance, fairness, efficiency and transparency in securities transactions provides the key for businesses to grow by meeting the CMA conditions in order to raise funds via listing for their expansion activities.

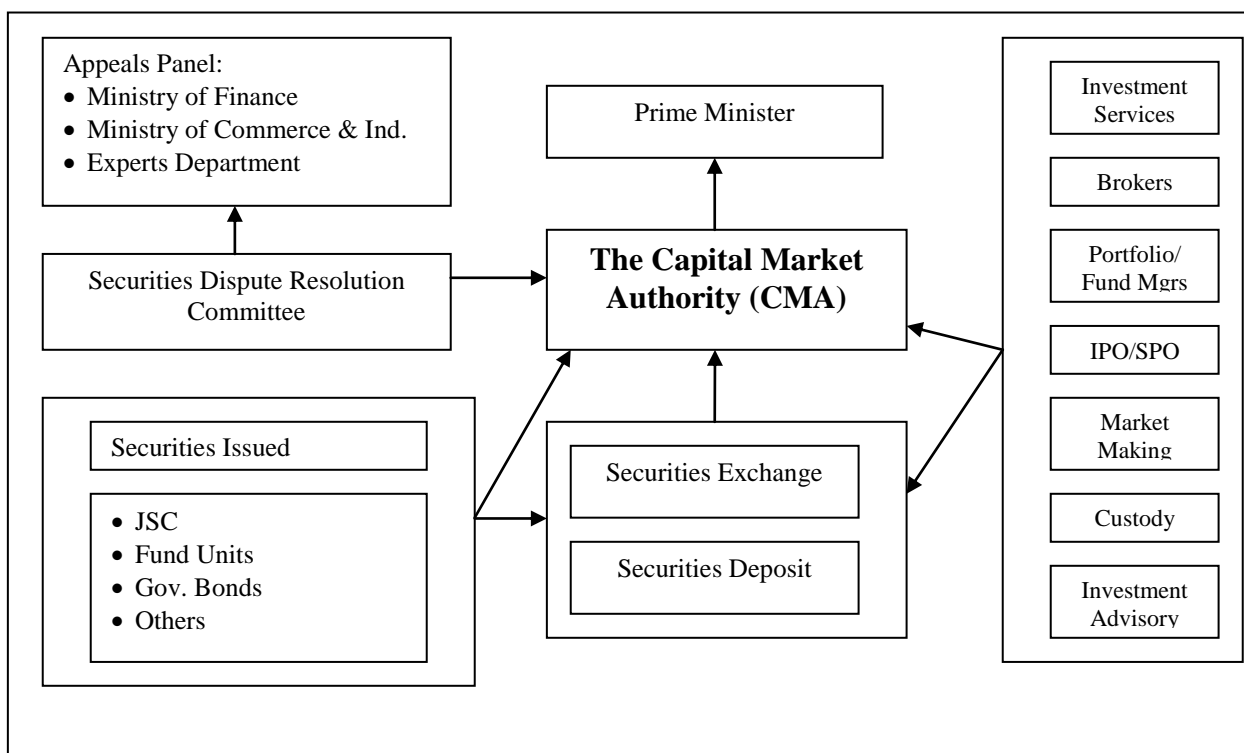
Other tasks of the CMA are to develop measures to reduce the risks pertaining to securities transactions; to develop, regulate and monitor the issuance and trading in securities; to regulate and monitor full disclosure of information for transparency and accountability related to securities and their issuers; and to regulate proxy and purchase requests and public share offerings.

A report released by the CMA illustrate that the total value of the 62 initial public offerings (IPOs) in 2006 in Saudi Arabia amounted to approximately SR28 billion which is largest number of IPOs since the establishment of the CMA.

The major challenges facing the CMA were the serious lack of rules and regulations for structuring the capital market, the existence of unlicensed advisory offices, a high percentage of shares owned by founders and board members, and inexperienced public investors in the Saudi equity market (Ramady, 2005).

In June 2003, the Saudi cabinet passed a new Capital Market Law comprising 67 Articles and creating an independent Capital Market Authority to protect investors' interests, ensuring systematic and enhanced dealing in securities for a better capital market.

Figure 3.10 the new Saudi Capital Market regulatory skeleton



Source: (Ramady, 2005)

Ramady explains that the Saudi authorities came to a decision to decentralize some productive industries particularly the non-oil industries like the financial services industry to bolster the economy. The CMA will be the driver in the following areas:

- i) Firstly, attracting Saudi investment capital from abroad;
- ii) Secondly, the development of the domestic Saudi Capital Market will contribute directly to higher growth of the financial services industry by providing professional investment management and advisory services to the public;
- iii) Thirdly, upgrading risk management of the economy by introducing new financial instruments into the market to manage volatility resulting from unpredictable oil prices;
- iv) Fourthly, the CMA has the capability to help the government privatise many public industries and promote the private sector to take the initiative

in developing mega-infrastructure projects and attract Foreign Direct Investment (FDI) into the economy (Ramady, 2005).

Dubai International Financial Centre (DIFC)

The Dubai International Financial Exchange (DIFX) which is operated by the DIFC has been recognized for becoming a major regional exchange for Sukuk listing with the highest value in 2006 worth more than \$16 billion (Global Islamic Finance 2007). The DIFC introduced its DIFC Sukuk Guide in 2009 as a comprehensive introduction to different Sukuk structures. The Guide also provides legal and regulatory information on issuing Sukuk from the DIFC, and listing of Sukuk on the NASDAQ Dubai Exchange (Investors Offshore 2009).

The straightforward and efficient listing process of Sukuk at the DIFC has enabled it to gain a substantial advantage compared to other regional Sukuk markets. Also, the modern and developed infrastructure of the DIFC also allows it to assist financial services resourcefully.

Since its launch in 2004, the DIFC has invited top financial institutions to operate within the Centre with the benefits of zero tax rate on profits, 100 percent foreign ownership, no restrictions on foreign exchange or repatriation of capital, operational support and business continuity facilities.

With the rapid growth of Islamic financial products, the DIFC was determined to focus on and promote the importance of the following significant areas of interest:

- i) economic expansion in the Arab world with emphasis on Shariah-compliant financing,
- ii) the emergence of international Sukuk markets,
- iii) rising demand for Islamic consumer financial products,
- iv) the rising demand for pension provision,
- v) the development of Shariah legal structures to support the progress of a contemporary Islamic financial system.

The vision of Dubai becoming the Islamic financial hub of the world is one of the main drivers behind the creation of the DIFC. Hence, the Dubai International Financial Exchange (DIFX) was established by the DIFC to operate a primary listing and secondary trading of Islamic financial instruments. The DIFX has since evolved into the Dubai Nasdaq following the merger between Dubai Bourse and Nasdaq.

The DIFC is considered one of the top locations for Sukuk issuance and trading around the world with a transparent and friendly business environment. The DIFC's unique experience as an independent jurisdiction within Dubai has helped promote Sukuk in the region and could benefit the Saudi Arabian Sukuk market potential with its vast experience. The DIFC has been leading the way in attracting global Sukuk issuers.

Central Bank of Bahrain

The Central Bank of Bahrain (CBB) is a public corporate entity which succeeded the Bahrain Monetary Agency. The CBB role is to regulate the monetary and financial policies of the Kingdom of Bahrain including monetary and foreign exchange rate policies, to manage the government's reserves and debt issuances, and to issue national currency. CBB's responsibilities also include standardizing the Bahrain Stock Exchange (BSE) and capital markets and acting as the Listing Authority of companies and financial instruments listed in the BSE.

Bahrain is considered as another major regional center of Sukuk because of its strong regulatory environment. The CBB has been successful in helping investors to diversify away from pure equity and real estate funds by issuing sovereign Sukuk on a regular basis since 2005 on behalf of the government of Bahrain. The CBB has been effectively managing its domestic liquidity by issuing Sukuk steadily to expand and diversify its funding resources. Also, Bahrain is home to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

Bahrain has emerged as a major centre for Sukuk with many Islamic financial institutions incorporated there. Over the years Bahrain has pioneered the issuance of Government Sukuk including short-term Sukuk Salam and the longer-term Sukuk Al-Ijarah. Bahrain is also host to several trans-national Islamic financial organizations such as:

- i) The Accounting and Auditing Organization of Islamic Financial Institutions (AAIOFI),
- ii) Liquidity Management Center (LMC),
- iii) The International Islamic Financial Market (IIFM),
- iv) The Islamic International Rating Agency (IIRA).

To help promote Sukuk further, both DIFC and BBC are attempting to standardize the regulations relating to Sukuk issuance and other Islamic financial products. These two pioneer regional Sukuk hubs can benefit the Saudi Arabian Sukuk market by reviewing their experiences whether positive or negative, and to build on those experiences for a better Sukuk market.

With regard to the legal validity or implications for DIFC and CBB in Saudi Arabia, the nations of the Gulf Cooperation Council which consists of Saudi Arabia, UAE, Bahrain, Oman Kuwait and Qatar, entered into an Agreement on the Execution of Rulings in 1995 (known as the GCC Convention) for recognition and enforcement of both court judgments and arbitral awards without re-examination of the merits (Al-Ghazzawi & Smith, 2010/2011).

Conclusion

As part of the financial markets, Sukuk are profoundly exposed to the condition of the financial markets in Saudi Arabia as an emerging asset class. Since, 2006, the Sukuk market have been increasingly tapped by major Saudi corporate entities due to the rising demand by investors because of the expanding activities of the financial markets in Saudi Arabia. Thus, it is essential for Saudi Arabia to develop a full range of financial and economic policies and measures to face the broad aspects of the challenges presented by a cyclical global economy. The 2008-9 global economic crisis has resulted in a global

recession that caused unstable oil prices and therefore affecting revenues in the following years for the Saudi Arabian government. This could put an extra strain on the Saudi economy. The Saudi government needs to consolidate its commitment to continuing its infrastructural investment restructuring, with its plentiful cash reserve that has cushioned the country from the 2008-9 economic upheaval and diversify its infrastructure financing modes (AlJaziracapital, 2010).

However, regulators have a major responsibility to continue their conservative financial policies in controlling the local financial investment from getting out of hand, a situation we are as of end of 2011 witnessing in major global financial markets.

Chapter Four

Corporate Finance in Saudi Arabia

Introduction

One of Saudi Arabia's principal economic challenges is how to empower the private sector to take over the driving seat in the development of the national economy as part of a strategy to diversify its economic revenues away from oil. Another challenge is how to create hundreds of thousands of new jobs for a youthful population where about 60 percent is under the age of 25 years.

In November 2002, the Saudi government announced a massive privatization plan to open some 20 sectors to the private sector and to foreign direct investments. However, the absence of long term financing tools has been one of the most important challenges facing major corporations in Saudi Arabia.

In this chapter, I examined the strategies of the private sector in securing long-term financing from the banking industry, which accounts for some 82 percent of the Kingdom's total funding requirements (Al-Jazira Capital Research, 2010). This chapter will demonstrate the buoyant potential need for corporate Sukuk that could be issued by big companies and banks in Saudi Arabia as a tool to raise financing. This will establish grounds for further supporting my thesis of recent trends and positive expectations of corporate Sukuk issuance in Saudi Arabia.

Although public agencies in Saudi Arabia have been providing funding for the private sector in the form of soft loans, Saudi banks have been also a major source of funding for the private and public sectors' development mainly in the forms of bank and syndicated loans in participation with global banks. The banking system in Saudi Arabia is considered to be one of the best in emerging markets, mainly due to the country's huge oil revenues and its availability for local investment and infrastructural development funding. With a Saudi population of 26.3m, a Gross Domestic Products (GDP) of

USD389 billion, and vast banking assets totalling USD293 billion, the banking sector has been enjoying huge liquidity as a result of record oil proceeds, which constitute 55 percent of the country's GDP. This inflow of revenues led to a boom in terms of loans and deposits during the 2003-2008 period (ALMAL CAPITAL, 2008).

Saudi banks have been dominating the nation's financial system with 11 local commercial banks representing 95 percent of total banking assets. Moreover, under the regulatory and supervisory regime of SAMA, Saudi banks are required to adopt best practice in international accounting standards. They have implemented most of the recent Basel Core Principles for embracing capital adequacy, asset quality, loan loss provisioning, related party exposures, and liquidity risks (Kypreos, Theofilou & Haladjian, 2008). Financial disclosure is considered to have progressed significantly lately, while SAMA is regarded as one of the most prudent supervisory bodies in the emerging world. SAMA's monetary and regulatory approach has enabled financial institutions to be prudent with a range of risk/return investment products. SAMA's requirements for commercial banks reserves ratios are one of the highest in the world and are also being used as a tool to control inflationary cycles (table 4.1).

Table 4.1 Commercial banks reserves (Millions Riyals)

	2003	2004	2005	2006	2007	2008(March)
Cash in vault	4,257	4,474	7,201	12,218	10,019	10,103
Deposits with SAMA:						
Current deposits	847	3,415	2,238	1,012	3,143	1,929
Statutory deposits	15,465	19,090	21,039	23,759	36,142	42,806
Other deposits	6,094	5,056	2,167	15,072	59,310	57,657
Bank Reserves	26,663	32,035	32,646	52,061	108,614	112,495
Ratios (%) to bank deposits						
Cash in vault	1.2	1.0	1.5	2.1	1.4	1.3
Deposits with SAMA:						
Current Deposits	0.2	0.8	0.5	0.2	0.4	0.3
Statutory deposits	4.3	4.4	4.3	4.0	5.0	5.6
Other deposits	1.7	1.2	0.4	2.5	8.3	7.6
Bank Reserves	7.4	7.3	6.7	8.8	15.1	14.8

Source: (SAMA Report, 2008)

Saudi commercial banks offer a wide spectrum of banking and investment products and services to retail and corporate clients. Due to the protectionist strategy of the banking industry in Saudi Arabia, SAMA has not granted any new operating licenses in the 1990s whether for domestic or foreign promoters. Not surprisingly, Saudi banks largely focused on the lucrative retail and consumer loans sectors, underpinned with high interest rates, and taking advantage of the limited local competitive environment. They effectively ignored the debt market, which subsequently remained underdeveloped for a long time. Moreover, long-term corporate finance remained relatively under-developed, as manifested by the fact that most mega-projects financing were lead arranged by non-Saudi based banks via syndicated loans.

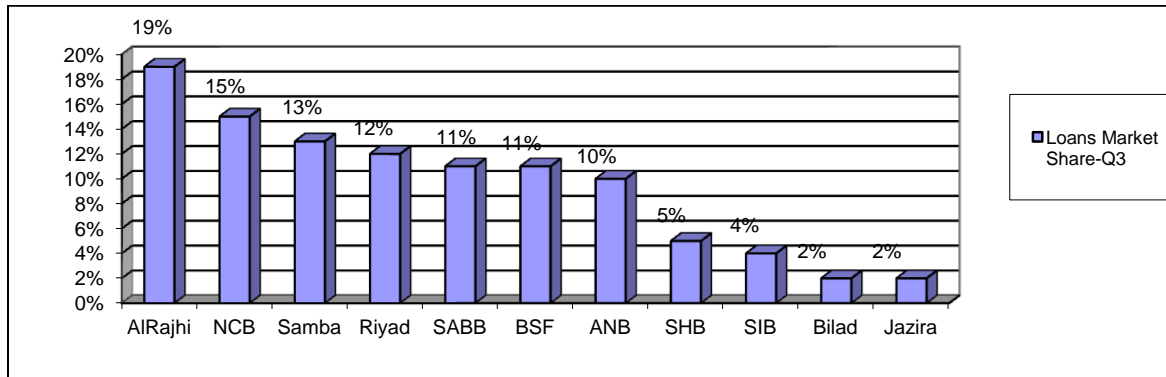
The Saudi banking system is considered to be the most sound in the region, with strong financial performance, high capitalization, ample liquidity, a strong deposit base and risk management strategies, and strict banking regulations and supervision (S&P's, 2007). With the creation of the CMA in 2003, Saudi Arabia has regulated the financial investment industry by instructing banks to create a "Chinese Wall" system within their investment divisions and incorporating them into independent entities. The main activities for the newly established investment institutions will be corporate finance, investment banking and asset management including brokerage, portfolio management, structuring and advisory services, and custodial services for securities. The wider objective is to develop the equity and debt market. The Kingdom has announced a staggering SAR1,900 billion program of infrastructure mega-projects to be launched over the next decade or so. As such, banks are faced with huge opportunities to provide project finance, syndication, structured finance and Islamic and conventional debt finance.

Bank Loans

The Saudi banking sector has grown strongly with cautious loan and deposit ratios over the first 3 Quarters of 2008 (30% and 19% respectively). The largest proportion of customer deposits are in non-interest bearing and non-demand deposits. The low Loans/GDP of 41.5 percent as of 2007, has made the Saudi banking sector very attractive, as does its young population (over 60 percent are below 25 years), impending

mortgage law, and the proposed mega-infrastructure projects. However, with the biggest Saudi banks carrying 91 percent of loans as demonstrated in figure 4.1, the loans exposure and concentration is high (ALMAL CAPITAL, Nov. 2008).

Figure 4.1: Loans Market Share



Source: (Al Mal Capital, 2008)

The strong growth of the Saudi economy fuelled consumer confidence. This resulted in the increase in the provision of consumer credit, project finance, corporate finance and asset management. Investor and consumer confidence in the local economy have driven loans and advances to increase substantially in the last few years. With an unprecedented expansion rate in public and private sector projects, loan demand for 2008 increased significantly with banks depending more on inter-bank borrowings to meet this increasing market demand (Kypreos, Theofilou & Haladjian, 2008).

Total bank demand on the private sector (loans, advances, bills discounted and investments) increased by 19.8 percent from SR 125.8 billion to SR 760.9 billion in 2007 compared with an increase of 6.6 percent (SR 39.1 billion) in 2006 (Table 4.2). This demand represented 106 percent of total banks deposits against 107 percent in 2006. The private sector has been the main driver of bank credit provision.

The combined bank claims on the private sector in 2007 grew by 21.4 percent, from SR 102 billion to SR 578 billion, against growth of 9 percent in 2006 of SR 40 billion. Bank claims on the private sector correspond to 81 percent of bank deposits for 2007, the same as in 2006 (SAMA Report 2008).

Table 4.2: Bank Claims on the Private & Public Sector (Million Riyals)

	2005		2006		2007		2008 (March)	
	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
Claims on private sector	435,926	73.1	476,020	75.0	577,882	75.9	625,966	73.8
Bank credit	420,828	70.6	462,103	72.8	557,405	73.3	606,647	71.5
Loans and advances	409,733	68.8	451,875	71.2	549,884	72.3	600,362	70.8
Bills discounted	11,096	1.9	10,228	1.6	7,521	1.0	6,285	0.7
Investments in private securities	15,097	2.5	13,917	2.2	20,476	2.7	19,319	2.3
Claims on the public sector	159,478	26.8	158,218	24.9	181,613	23.9	220,819	26.0
Bank credit to non-monetary financial public sector enterprises	31,672	5.3	34,965	5.5	37,434	4.9	34,032	4.0
Investments in government securities	127,806	21.4	123,253	19.4	144,179	18.9	186,787	22.0
Treasury bills	715	0.1	9,131	1.4	16,748	2.2	58,460	6.9
Government bonds	127,091	21.3	114,122	18.0	127,431	16.7	128,327	15.1
Claims on non-monetary financial institutions	538	0.1	837	0.1	1,429	0.2	1,354	0.2
Total	595,942	100.0	635,075	100.0	760,924	100.0	848,140	100.0

Source: (SAMA Report, 2008)

Gross banks loans, including overdraft facilities, structured term loans, finance against receivable and trade finance, have increased sharply by 21 percent from 2006 to 2007. The total domestic credit facilities had jumped by 20 percent, with the commercial industry heading the credit portfolio accounting for 22 percent of the total credit in the First Quarter of 2008. Similarly credit flows to the transport and communications sectors also surged by 205 percent (Samba 2008).

The surge in bank loans in 2007 is largely due to a new collateral system based on the monthly benefits of public and private sector employees. This enabled some 5.2 million people to access bank loans or to finance purchases, of which Saudis accounted for 4.8 million and non-Saudi expatriates accounted for 460,000. The lion's share of loans were for financing automotive purchases or leasing, followed by real estate purchases and stock market investments as shown in table 4.3. This increased competition between banks in financing consumer credit which in itself became a driver of demand.

Consumer loans by commercial banks reached an astonishing SR312 billion (AlMubarak, 2008).

Table.4.3: Consumer & Credit Card Loans (Million Riyals)

Year	Real estate	Motor Vehicles and equipment	Others	Total	Credit Card Loans
2003	5,191.5	28,858.8	39,254.6	73,304.8	2,579.1
2004	8,790.0	27,926.3	78,589.7	115,306.0	3,295.2
2005	13,656.3	29,025.5	138,173.9	180,855.7	4,259.2
2006	13,690.0	34,261.8	132,758.6	180,710.4	7,349.4
2007	15,630.7	37,578.0	129,379.3	182,588.0	8,896.0

Source: (SAMA Report, 2008)

In addition to the commercial bank lending, there are specialized credit institutions that also provide loans, like the Saudi Industrial Development Fund (SIDF), Real Estate Development Fund, Saudi Arabian Agricultural Bank, Public Investment Fund and Saudi Credit and Savings Bank. These funds are supported by public agencies, in charge of government social, development and industrial programs, which had total assets of SR319.8 billion at the end of 2007. Total funds disbursed by government programs surged by 62 percent or SR16.5 billion in 2007 compared with the previous year.

There are many Saudi specialized institutions incorporated to organize and sustain the required credit for the development of the private and public sectors (Table 4.4). However, these are heavily funded by the government, exposing them to the volatility of government revenues. Thus, the existence of a debt market would stabilize the funding of long-term projects.

Table 4.4: Activity of Specialized Credit Institutions (Million Riyals)

	Loans Disbursed			Repayments			Outstanding Loans		
	2006	2007	Change (%)	2006	2007	Change (%)	2006	2007	Change (%)
Saudi Industrial Development Fund	2,951.1	4,244.0	43.8	1,658.4	1,525.4	-8.0	11,138.5	13,857.0	24.4
Real Estate Development Fund	3,964.7	3,558.2	-10.3	1,829.5	2,038.5	11.4	71,240.9	73,392.7	3.0
Saudi Arabian Agricultural Fund	723.3	664.8	-8.1	475.5	683.5	43.8	9,450.9	9,431.7	-0.2
Public Investment Fund	1,820.4	7,005.6	284.8	1,471.9	2,256.5	53.3	17,817.7	22,566.8	26.7
Saudi Credit & Saving Bank	736.0	1,039.8	41.3	486.0	554.1	14.0	1,313.4	1,799.1	37.0
TOTAL	10,195.5	16,512.3	62.0	5,921.2	7,058.0	19.2	125,461.4	135,547.3	8.0

Source: (SAMA Report, 2008)

Overdraft Facilities

Overdraft facilities are an important form of short-term borrowing, and most short-term loans are issued in the form of self-liquidating overdrafts. Credit facilities provided to public enterprises increased by 7.1 percent in 2007 against a growth of 10.4 percent in 2006. These facilities are important to these enterprises in financing their operations and ensuring their survival and sustainability over economic cycles, and helping to reduce the current mismatch between their long-term assets and their liabilities. Therefore, the existence of a Shari'a-compliant instrument such as Sukuk is essential for diversifying the sources of financing for companies from different industries to replace the conventional short-term overdraft facilities. Private contractor Saudi Binladin Group has issued the first short-term (nine months) Sukuk in 2010 and 2011, opening a new opportunity for contractors to source funding in the midst of difficult lending environment (Karam, Arabian Business, 2010).

In terms of credit facilities by their maturity period, short term lending accounted for 58 percent of the total credit facilities of SR 595.5 billion in 2007. The trend continued in the first quarter of 2008 with short term lending accounting for 59 percent of the total. Medium term lending and long term lending in 2007 had a share of 14 percent and 28 percent, respectively. Going forward, with the increasing activity in the real estate sector,

long term credit facilities are expected to grow at a faster pace as compared to other types of facilities (SAMA 2008).

Aggregate consumer loans in Saudi Arabia increased by 2 percent from SR 188.3 billion in 2006 to SR 191.3 billion in 2007, the highest annual loan growth of 21 percent was experienced in the credit cards sector. Real estate financing by banks recorded a five-year Compounding Annual Growth Rate (CAGR) of 28 percent, reaching SAR 1 billion by the end of 2007 while SAMA restricts direct mortgage lending as it is considered to be an illiquid asset. The auto and equipment lending sector accounted for SAR 36.75 billion in the first quarter of 2008, and continues to lead the consumer loans segment. This was followed by the facilities extended for real estate financing (SAMA 2008).

The unique feature of business in Saudi Arabia is that it is overwhelmingly owned and managed by families because of the indigenous social structure. Even the biggest listed banks were founded by families, and are still largely family owned, ranging from Al-Rajhi Bank to the National Commercial Bank, in addition to other banks which are also mainly owned by influential families and which promote their family members to the board of directors. In recent years, family-owned businesses have been modernized through their restructuring ownership by part-listing them in the local equity market.

However, corporate exposure to Saudi banks' overdraft facilities is limited, and less than 50% of Saudi firms have overdraft facilities. The culture of over-reliance on short-term overdraft facilities is not widespread among corporates in Saudi Arabia due to the negative perception that it is costly financing, which requires more transparency and disclosure to banks. This is not seen favourably among corporate entities that are mostly owned by family businesses in Saudi Arabia (Al-Shaikh 2008).

Saudi banks also in general are averse to give short-term financing for corporates because most of them do not have audited balance sheets, lack transparency and disclosure, and present unsubstantiated feasibility studies. This is why premiums for lending to corporate entities are relatively high, as they cover the high risk they pose due to the limitations in their corporate governance. Consequently, companies depend heavily on retained

earnings for financing their operations and expansion, which is relatively easy as they have been enjoying extraordinary returns as a result of a booming petro-dollar Saudi economy.

Yet they are the first victims in an economic downturn, as financing becomes too difficult to obtain, and their survival is threatened in the absence of financing. In spite of this, there is a great potential for long-term debt financing tools like Sukuk in Saudi Arabia, for companies to obtain long-term financing with favourable terms for a lower premium. This will also enhance the culture of corporate governance.

Government-owned corporations however can take advantage of their many layered relationships with banks and obtain relatively cheap funding for their businesses. This is reflected in their growth. However, many influential families, who own major stakes in both banks and companies, are securing cheap financing for their companies from banks in which they hold major stakes, which is creating situations of conflict of interest for the banks. Nevertheless, large corporations are heavily dependent on short-term overdraft facilities and bridge financing.

The Saudi Industrial Development Fund (SIDF) provides loans for industrial projects, and for businesses investing in manufacturing or producing products with low or no financing premium. The government has recently increased the capital of SIDF, and has extended the period of repayments, as well as increasing the ceiling of loans for each project. For the last few decades, the SIDF has been active in the financing of many of manufacturing projects, although its role depends heavily on the financial support of the Saudi governments.

The Ministry of Finance approved a loan guarantee scheme which was launched in 2006 by SIDF to cover local corporate lending offered by Saudi commercial banks. Corporate entities are classified as those with assets of SR50 million or less, and with maximum employees of 250 and maximum turnover of SR10 million. The most important factors in the scheme include:

- (i) an initial contribution of SR200 million, funded half by the ten commercial banks,
- (ii) a guarantee fee and SIDF handling charges to the banks of about 175 basis points,
- (iii) guarantee ceilings of SR1.5 million and 75 percent of the underlying loans;
- (iv) durations of seven years on fixed assets and four years on working capital; an
- (v) and a cap on bank lending rates of 400 basis points over the Saudi Inter-bank Offer Rate (SIBOR).

The Fund contributions will be invested by the SIDF to generate returns for the scheme and hold collateral against any default. In the case of default, banks will notify the SIDF, which will execute the collateral construed under the Public Collection Act, which provides for an expedited collateral enforcement process without reference to the Shariah court. Banks are also guaranteed to receive 75 percent of their loans within three months of the declaration of default (IMF 2006).

This program has been very affective in securing lending to companies with favourable terms as long as there is excess government liquidity. However, the effectiveness of these programs becomes very limited once oil prices decline along with government revenues. Once again the case for a sustainable debt market with long-term and Shariah-compliant instruments like Sukuk to meet the rising demand for prolonged financing becomes imperative.

Structured Term Loans

Overall, it is believed that the banking sector in Saudi Arabia, due to the increasing participation and competition from foreign banks, is becoming increasingly competitive and domestic banks need to gear up for market competition. Growth opportunities are abound in the region for players who are willing and prepared to meet the challenges. The market segments that hold attractive growth potential include private and priority banking, small-and-medium-sized enterprise (SME) services, bank-assurance, mortgages, and Islamic banking.

Islamic banking is one of the strongest growth markets with an estimated 15 percent growth rate per annum. Corporate Sukuk are the most promising to lead the growth in the debt market. Corporate Sukuk issuances to date in Saudi Arabia, such as the SABIC and the Saudi Electricity Company (SEC) originations have been heavily oversubscribed. SAMA and the CMA, together with market players are in the process of developing an appropriate framework to facilitate the greater issuance of corporate Sukuk in the future and the role they can play in developing the Saudi capital market.

As banks in Saudi Arabia have been mainly focusing on retail banking, which has a high return and low risk, it is imperative to develop their proficiency in structuring and arranging Sukuk in partnership with conventional banks, which have proven experience in arranging conventional bonds. A key step in this direction has been the recent decision by the CMA to require banks to separate retail banking and investment banking businesses. This aim is for the investment banking entities to develop their capacity in arranging Sukuk and other capital market instruments. Most of the recently issued Sukuk were arranged by conventional banks such as HSBC Saudi Arabia, Riyad Bank and Saudi Hollandi Bank.

Short-term credit

Short-term credit (3-9 months) to the private and public sectors increased sharply by 30 percent or SR 71.4 billion to SR 347.6 billion in 2007 – compared with an increase of 10 percent or SR25.4 billion in 2006 (SAMA Report 2008). These statistics show the increasing demand for short-term financing in recent years as the commercial culture of businesses is growing more sophisticated in terms of funding. Furthermore, with the sharp rise in Shariah-complaint financing, more companies are exploring the prospects of engaging in long-term financing instruments like corporate Sukuk (Table 4.5).

Shariah-compliant financing instruments like “Murabaha” and “Tawarruq” have been popular among companies for short-term financing. Most companies are owned by family businesses that only use Shariah-compliant financing.

Medium-term Credit

Medium-term credit (1-3 years) increased by 28.7 percent (SR 18.6 billion) to SR 83.2 billion in 2007 against an increase of 20.8 percent (SR11.1 billion) in 2006 (SAMA Report 2008). This demonstrates strong growth in medium-term credit as demonstrated in Table 4.5. However, the lack of availability of Shariah-compliant financing instruments such as corporate Sukuk is compelling companies to engage in medium-term bank loans with a high premium.

Medium-term funding would enable corporations to employ this type of financing for more complex operations. Medium term credit has been mainly utilized for real estate financing which requires medium term credit maturity. In spite of this, even real estate development companies in Saudi Arabia such as Dar Al-Arkan are looking forward to using Sukuk as a long-term financing due to the fact that real estate development takes years of investment and development by stakeholder to realize their investments.

Long-Term Credit

Long-term credit (more than 3 years) soared by 5.0 percent (SR 7.8 billion) reaching SR 164.0 billion in 2007 against a rise of 5.4 percent (SR 8.0 billion) in 2006. This slower growth than the previous year shows how long-term financing is seriously under-developed, for the reason that there is no transparent legal and regulatory framework and systemic infrastructure for long-term credit for both debtors and creditors. The modest increase of 0.4 percent year-to-year for long-term credit demonstrates the need for well regulated long-term credit for large scale organizations which anticipate major expansion as shown in table 4.5. Sukuk laws, Sukuk trust laws and laws governing Special Purpose Vehicles (SPVs) for the development of Sukuk structures are essential for the progress of the Shariah-compliant debt market.

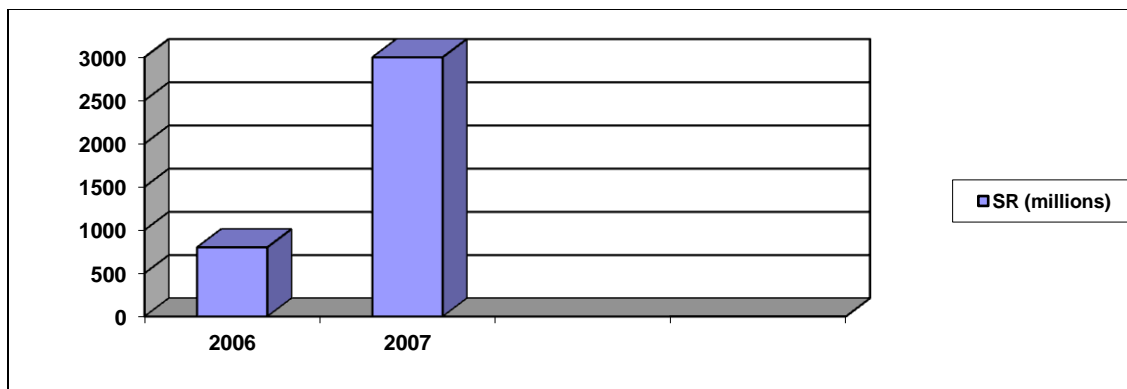
Table 4.5 Classification of Bank Credit by maturity (Billion Riyal)

	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008
Short-term loans	276.2	275.2	298.2	324.3	347.6	397.5
Medium-term loans	64.6	79.4	70.7	75.9	83.2	91.9
Long-term loans	156.2	148.4	163.2	167.7	164.0	169.3
TOTAL	497.1	503.0	532.1	567.9	594.8	640.7

Source: (SAMA Report, 2008)

Saudi private sector credit is to a large extent correlated to the machinations of oil price movements. The higher oil prices go, the more liquidity in the Saudi market, producing easier access to the credit market for both private and public financing requirements. The Saudi Arabian Inter-bank Offered Rate (SIBOR) is the benchmark reference for gauging the overnight lending rate among Saudi banks. However, there is no official interest rate structure in Saudi Arabia, as SAMA relies substantially on orienting the level of inter-bank liquidity via the repo window, consequently impacting the short-term money market. Thus, the commercial financing rates of banks strongly affect both capital expenditure and corporate borrowing (El-Quqa, O., Dash, S., Hasan, F., Bhatt, C., Tripathy, A. and Mafatia, M., Global, 2006). However, some banks like Samba Financial Group and SABB Bank (formerly Saudi British Bank) have issued European Medium Term Notes for long-term financing. Saudi Hollandi Bank has been the only local bank to issue Sukuk to finance expansion, operations and to restructure existing debt. Sukuk issued by Saudi banks increased by 252.1 percent to reach SR 3.0 billion in 2007 as illustrated in figure 4.2. However, this has to be put in perspective given the low base of Sukuk origination in the Kingdom (SAMA Annual Report, 2008).

Figure 4.2: Sukuk Issued by Domestic Banks



Source: (SAMA, 2008)

In addition, the Saudi Arabian monetary system, as a main driver of the credit market, is considered to be an open and flexible one. Accordingly, interest rates are influenced by two factors - firstly, Saudi Arabia is an open economy, with free Saudi Riyal currency convertibility; secondly, Saudi Arabia has a pegged exchange rate.

As the price of oil is in dollars, Saudi Arabia had to fix its national currency to the US Dollar as its benchmark since 1986 with USD1 = SAR3.75. For that reason, the Saudi monetary system is relatively positively correlated with the United States monetary system. Furthermore with the unavailability of a totally independent interest rate structure, SAMA controls the inter-bank market by the repo window, which consequently impacts short-term interest rates (Dr. Al-Jasser & Banafe 2006).

Finance against Receivable Trade Finance

Saudi Arabia is a leading export and import market – one of the top five in the Islamic world, along with Malaysia, Turkey, Indonesia and UAE. However, Saudi foreign trade has gone through a major transformation in the last few decades due to the economic diversification programmes which Saudi Arabia has been adopting to off-set its trade deficit (Wilson, 2003).

The Saudi economy has been expanding considerably and more industries are developing, with more reliance on productive imports. As Saudi Arabia has been recording hefty trade account surpluses for the last few years, because of record oil proceeds, import finance have been growing in sophistication mainly in the form of Letters of Credits (L/Cs), bank guarantees and overdraft facilities. Saudi commercial banks are the main financiers for private sector imports and exports via LCs and bills received. The contribution of the private sector to GDP mainly through increased export/import activity is slowly growing. With the private sector taking over the initiative of greater funding of major Saudi imports and exports, the government has supported such efforts by instituting a solid imports/exports regime (Moabi, Thomas, Markovski, Alexnader, and Fyfe, QNB Capital, 2011).

Saudi banks have enjoyed good returns on trade finance due to the simplicity of the process, high turnover, low risk and short-term maturities (Banafe, 1993). Banks and

major corporations which are specializing in trade finance can also issue long-term Sukuk to finance against trade receivables.

Imports and exports financed through commercial banks do not reflect the true value of imports and exports. A large chunk of non-oil exports, for instance, has been settled through specialised financing programmes such as the Saudi Export Program, Exports Finance Program of the Islamic Development Bank (IDB) and the Arab Trade Finance Program of the Arab Monetary Fund (AMF). This involves direct transfers to exporters' accounts (SAMA Report, 2008).

Table 4.6: Private Sector Exports Financed by Commercial Banks

	Million Riyals				Share %				Change %	
	Year		First Quarter		Year		First Quarter		Annual	Quart.
	2006	2007	2007	2008	2006	2007	2007	2008		
Agric. & Animal Prdts	92	302	484	35	0.4	1.0	7.0	0.4	228.3	-92.8
Chem. & Plstc Prdts	6,362	6,691	1,990	1,554	26.1	21.7	28.8	19.3	5.2	-21.9
Other Indus. Prdts	17,876	23,794	4,430	6,477	73.5	77.3	64.2	80.3	33.1	46.2
Total	24,329	30,786	6,904	8,066	100.0	100.0	100.0	100.0	26.5	16.8
Ratio of total to non-oil Exp.	23.8	28.5	29.5	-	-	-	-	-	-	-

Source: (SAMA Report, 2008)

Most Saudi imports financed by commercial banks are received on the basis of an irrevocable letter of credit (L/C) with minimum restrictions and conditions and a time frame of a few months. Commercial banks statistics demonstrate an increase of 27.4% of the above form of trade finance to SR 168.5bn in 2007 – up from SR 132.3bn in 2006. Commercial banks accounted for 50.6% of Saudi import financing in 2007 - the same percentage as in 2006 (SAMA Report, 2008).

Saudi Arabia relies heavily on imports and therefore foreign exchange policy has a major influence in deciding the source of imports. As the riyal is pegged to the dollar, any appreciation or depreciation against the dollar affects the value of the Riyal value against the importing country's currency and prices. Nevertheless, SAMA is determined to retain the official peg of the Saudi riyal to the dollar in accordance with the prerequisites of the Saudi economy; the decision of the Gulf Cooperation Council (GCC) member countries to take on the US dollar as a common anchor for their currencies; and the maintenance of an unchanged exchange rate regime in anticipation of GCC Monetary Union in 2010/11 (Khan, 2009).

The Saudi riyal is considered to be a local currency without any role in the global foreign exchange trading market. As a result, the riyal has been utilized by upholding stable exchange rates against the dollar. Despite the apparently unconstrained global financial capital and trade flow, and *laissez faire* style adopted by Saudi Arabia, SAMA has been controlling monetary policy in terms of liquidity management, interest rates and exchange rates.

For the last few years, Saudi Arabia has been successful in building its foreign exchange reserve and placing most of the proceeds from high oil prices in limited risk securities like the US Government Treasuries at fixed return. Nonetheless, with the increasing trading of Saudi Riyal, and a surging foreign exchange outflow, Saudi market short-term liquidity is increasingly facing imbalances. As the government is the largest foreign exchange generator in the Saudi economy, most of the public sector's foreign exchange reserves are all in dollars, to support Saudi trade and to finance imports (Aridas, Global Finance, 2010).

The accession of the Kingdom to the World Trade Organization (WTO) in 2006 has changed the dynamics of its import system, although Saudi Arabia continues to conduct open trade relationships with its partners, operating minimum tariffs. Saudi Arabia's admission to the WTO reduced import tariffs from around 15% to 7%, with additional

decreases scheduled in the future. However, before 2006, the Gulf Cooperation Council (GCC) countries, in collective action, lowered their tariffs in January 2003 in addition to operating duty-free trade for products originating within the GCC under the condition that 40% of value added is from within the GCC region (Ramady, 2003).

The globalization of financial services has accelerated very rapidly, more so than global trade. Yet the Saudi authorities were aiming to gradually free trade, and promote growth with limited restrictions on imports which could result in stronger Gross Domestic Products (GDP), improve business activity and productivity for an efficient allocation of resources (Wilson, 1997).

Informal Finance

Saudi companies interested in expanding their businesses in the decades up to 2003 had limited resources of financing. Bank loans were the most common source of financing for companies to meet their obligations. Hence, companies' reliance on the only source of financing which are bank loans has been a costly liability with a high debt/equity ratio, spending a sizable portion of their earnings on debt service (World Bank and IMF, 2005).

Since the creation of the Saudi Capital Market Authority (CMA) in 2003, equity financing has been developing considerably, enabling companies to raise financing for their expansion by offering some of their shares to the public through an Initial Public Offering (IPO). Yet offering equity to the public to raise financing has been more costly than debt financing in the absence of a developed debt market. That is why, the under-developed debt market in Saudi Arabia has been constraining Saudi companies from developing their full potential (The Economist, 2007).

The debt market in Saudi Arabia, when developed as intended, would offer more financing solutions to Saudi companies for more balanced combinations of equity and debt.

Family Finance (Loans or Equity)

Family business represents approximately 90 percent of companies in Saudi Arabia against 70 percent in the European Union. Nonetheless, the lack of transparency, and the lack of an asset valuation process, has been preventing family businesses from obtaining reasonably priced loans. Consequently, a number of family owned businesses prefer equity financing by offering some of their shares to the public through an IPO so as to be transformed into public companies. However, some family owned businesses fear going public as it dilutes their control of the company. Nonetheless, it is well known that family businesses are adding a great value the Saudi economic activities.

Family-owned businesses in Saudi Arabia are becoming aware of the need to evolve in order to continue being feasible and to survive during an environment of developing regulations, corporate governance and developing business mechanisms. Most new family businesses fail within the first three generations due to financing difficulties. This has a social and economic impact. Nevertheless, lately many mid-size corporate entities are seeking to raise financing via Initial Public Offers (IPO), which are cheaper than the overdraft facilities from the banking sector, and to corporatize their organizations in a market saturated with liquidity and a booming equity market.

Partnership Finance

As the economy has been experiencing an economic boom, many partnership companies have been established, and they have continued their growth in the last few years. These include limited liability partnerships, joint liability partnerships or mixed liability partnerships. However, financing for commerce has been an obstacle for some Saudi entrepreneurs, as they do not favour conventional banking financing for religious and cultural reasons. Thus partnership institutions have been based on the ability of partners to secure capital for their investment.

The Saudi Ministry of Commerce and Industry has licensed 2,196 partnership-type companies in 2007, against 1,639 in 2006, showing a strong surge of 25 percent, reflecting strong confidence in the Saudi business environment. The increase in joint-stock companies over the above period is due to the fact that many partnership companies had to be transformed into joint-stock companies as a pre-requisite for going public as shown in table 4.7 (SAMA Report 2008).

The ownership of partnership companies in the Saudi market reveals the broad dominance of family ownership within the business configuration. Many partnership companies were established, on the basis of self-financing, in an attempt to avoid conventional bank-financing which interest charges. Most entrepreneurs favour family members due to cultural and social factors. The absence of a clear legal framework for partnerships to protect the rights of investors and partners remains a major problem. As the legal system is underdeveloped in general, partnership companies are mainly limited liability companies to avoid any unclear legal exposure as shown in table 4.7.

Table 4.7: Number of existing Saudi companies by capital type

(Capital in Million SR)	2006		2007			Cumulative total up to 2007		
Type of Company	No.	Capital	No.	Capital	% Share in Capital	No.	Capital	% Share in Capital
Joint-stock Co.	34	31,115	78	43,527	84	308	412,153	72
Limited Liability Partnerships	1,508	16,334	2018	7,885	15	14,309	143,418	25
Saudi	1,094	2,926	1,498	4,344	8	11,213	82,746	15
Joint-venture	285	5,831	357	3,292	6	2,475	51,541	9
Non-Saudi	129	7,577	163	248	1	621	9,131	2
Joint-liability Partnerships	98	48	120	34	0	3,047	4,119	1
Saudi	98	48	120	34	0	3,012	4,087	1
Joint-venture	0	0	0	0	0	34	27	0
Non-Saudi	0	0	0	0	0	1	5	0
Mixed liability Partnerships	33	8	58	164	0	1,193	10,759	2
Saudi	33	8	58	164	0	1,183	10,721	2
Joint-venture	0	0	0	0	0	8	22	0
Non-Saudi	0	0	0	0	0	2	15	0
Mixed liability partnerships by shares	0	0	0	0	0	4	3	0
Total	1,673	47,504	2,274	51,610	100	18,861	570,451	100

Source: (Saudi Ministry of Commerce & Industry, 2008)

Equity Finance

The Saudi equity market has been experiencing a boom since 2003 with a flood of liquidity generated from the proceeds of high oil prices. Strong economic growth has been reflected in the equity market, with the flotation of many public companies and many family enterprises have offered shares to the public in order to raise funding for expansion. The surge in the equity market, witnessed over the period 2003-2006, was due largely to high liquidity, few shares listed and improvements in the listing rules and regulations by the Saudi Capital Market Authority (CMA).

However, between 2006 and Q1 2009, there has been a major correction in the equity market. These years have been a very difficult period for the Saudi equity market, just like most equity markets around the world. Planned company IPOs in Saudi Arabia were cancelled or delayed indefinitely. This had a knock-on effect in that many planned projects were similarly cancelled or delayed. The absence of active Shariah-compliant financing instruments, such as corporate Sukuk, exacerbated the market situation.

The Fourth Quarter of 2008 witnessed one of the sharpest declines in the equity market. The Saudi government was forced to finance infrastructure investments, its privatization programme from its reserves. At the same time, the government gradually started to part-liberalize foreign ownership laws and to tighten the regulations relating to family-owned businesses, particularly when these go public.

Saudi companies like Zain Telecom, Alinma Bank, Saudi Arabian Mining Company (Ma'aden) raised in total \$7.14 billion in 2008 via IPOs to build their balance sheets for large-scale expansion (Renaissance Capital, 2008). Nonetheless, developing the debt market in Saudi Arabia provides legal and financial support for promoting corporate Sukuk and bonds.

Private Equity

Private equity finance in Saudi Arabia has been growing considerably since the creation of the CMA, which led to it becoming a better regulated investment asset class. Private equity has been supplying a substitute source of funding to family and private shareholder companies for growth purposes. Furthermore, many companies are turning to private equity to raise funds for pre-IPO financing. For this reason, private companies are developing a tactical broadening of their shareholder base. Many private equity (smart capital) companies are being managed by expert teams specializing in better corporate governance, and viable restructuring for a successful IPO exiting strategy.

The volume of private equity in Saudi Arabia as a proportion of GDP is minimal, and is estimated at about 0.1 percent, against 1.5 percent in neighbouring countries such as the UAE. Private equity investors have been facing serious challenges in penetrating the Saudi market, because most of companies are family-owned that are averse to handing over control of management. They have high appraisals and projected returns, enjoy social privileges, and have a shortage of professional management, because they are reluctant to hand over professional management to a non-family member (Global Report, 2008).

Global Report identified air travel, telecoms, financial services, education, retail, healthcare, food and beverages, and transportation for potential privatisation. These sectors carry substantial opportunities for private equity investors who are willing to engage in growth industries.

Conversely, the Saudi market requires a deep understanding of the developing regulatory atmosphere and solid background knowledge of the cultural and social factors in the country, in order to accomplish profitable transactions, and not to get tangled in the bureaucratic business process.

Private equity funds are one of the principal and growing options for raising equity by private companies for strategic investment in Saudi Arabia. Furthermore, there are also the preferences of raising equity through pre-IPO funds, aiming at private companies which are planning to offer some of their shares to the public within few years. However, the CMA has only been allowing private companies with records of their average profits for the last three years as a pre-requisite to be offered to the public via an IPO, and consequently listed in the stock market (Azzam, 2007).

One of the best known private equity deals in Saudi Arabia was the investment by a regional private equity fund managed by Global Investment House (GIH) in Ajlan, a Saudi family owned-business retail textile company. This fund also has taken stakes in Al-Sawani and Modern Marafiq. Family-owned businesses in Saudi Arabia have been a target especially for global and regional private equity funds which are interested in taking advantage of the equity market and the beneficial exit strategies offered by these investments (Arab News, 2007).

Public Issuance

Public issuance has been the objective for many private companies in Saudi Arabia, especially family-owned businesses to ensure their sustainability in an evolving capital market.

Most of the rapidly emerging private businesses perceive going for an IPO as an important strategy for expansion, access to financing, an exit opportunity for private equity investors, and advancing their corporate image and brand. However, the CMA has implemented significant requirements in terms of corporate structure, business management and corporate governance. All these requirements will oblige companies, including family-owned businesses to implement major improvements and acquire better experienced professionals, to diversify their boards so they are not dominated by family members, and to include new shareholders and a new stakeholder base.

Listed companies on the Tadawul have increased considerably from 69 companies in 2003 to over 100 companies in 2009 with many companies going public via an IPO. Even the Tadawul Exchange Company itself has been transferred into a joint-stock company in order to be privatized through an initial public offering (IPO) in due time. The growth of the equity market has seen greater involvement by middle-class retail investors in the local equity market.

Many of these newly listed companies are looking forward to engaging in the debt market by issuing Shariah-compliant financing instruments like corporate Sukuk. The Governor of SAMA, Dr. Muhammed Al-Jasser, elucidated his perspective in his first public statement after his appointment as a Governor, in March 2009, which underlined the development of the debt market; by encouraging Saudi companies to issue Sukuk and bonds to finance their projects which is the next option SAMA is considering amid the current global financial and liquidity crisis.

Hence, the potential for corporate Sukuk in Saudi Arabia is huge to finance key sectors such as petrochemicals, telecommunications, power, mining, infrastructure and the development of the six economic cities across the Kingdom.

Syndicated Finance for Mega Projects

The Saudi syndicated borrowing market is rising steadily and it is expected to grow further as companies are planning major expansion via regional and global acquisition or the creation of new mega-projects. Until recently the debt market has been dominated by project financing, however, in 2007 and 2008 (pre-global financial crisis) syndicated loans had been experiencing a boom with the evolution of corporate financing. An increasing number of petrochemical and family-owned businesses, which are the biggest sector of the Saudi business structure, have been engaging in syndicated loans for their business expansion needs (McGrath, 2008).

The syndicated corporate loan industry prospered in Saudi Arabia over the last three decades because of the growth of acquisition financing, and the under-developed nature

of the debt and project finance markets. Syndicated loans provided by domestic banks to non-residents went up by 14.5 percent to 71 percent loans in 2007, and supply has been proliferating with balanced growth year-on-year (SAMA Report, 2008). Syndicated loans have been also increasing in average deal size with the Riyal and US dollar as the most frequently used currencies. Most borrowing organizations were from the petrochemical, energy and oil, and financial sectors encouraged by the Saudi government strategy to provide the feedstock for these industries at discounted prices.

For the last three decades, SAMA has been closely controlling the market for riyal-denominated syndicated loans and bonds. SAMA has asked global financial institutions on its depository list to obtain its approval prior to participating in any Saudi project and joint venture related syndicated loans, in an attempt to limit the control of global banks of the Saudi Riyal, and to pre-empt speculation on the Riyal. Hence, SAMA has restricted payment to Saudi banks of government investments in local project contracts which involve foreign investors in US dollars only.

Conclusion

From 2003 to mid-2008, the Saudi corporate finance market has been enjoying a liquidity surplus due to record oil revenues. This paved the way for an overhaul of the legal infrastructure and regulatory framework to allow for rapid growth. The creation of the Capital Market Authority has been a milestone in the unlocking of the corporate finance market for mega projects and family owned businesses (Kotilaine, NCB Capital, 2009).

However, the debt market is still to a large extent lagging the equity market, and is seriously underdeveloped and thus holding back the potential for expansion of many corporate entities. Recent issuance of corporate Sukuk as Shariah-compliant financing instruments is breaking religious and cultural taboos preventing Saudi Arabian firms from engaging in the debt market, as the conventional debt market is not Shariah-compliant. Sukuk are the best long-term financing instruments with favourable terms for companies, as Sukuk are securitized and liquid because they are tradable.

Sukuk can and should be a main source of financing for large corporate entities in vital sectors in the Saudi economy such as construction, oil and gas, petrochemicals, manufacturing, real estate, infrastructure projects and the new economic cities. Saudi Basic Industries Corporation (SABIC), Saudi Electricity Company (SEC), Dar Al-Arkan Real Estate Development Company (DAAR) and Saudi Hollandi Bank have all issued Sukuk to finance their operations, long term projects, or refinancing existing debt. Other Sukuk originations by several private and public companies are also in the pipeline. The corporate Sukuk market is expected to take off rapidly in the next few years, even in the absence of a developed legal and regulatory framework for the debt market, according to Trowers & Hamblins, an international law firm based in London (Watheeqa, 2010).

Some analysts attribute the recent regional corporate Sukuk boom to the massive inflow of oil proceeds, which made global banks and investors more involved in investing and issuing, once they understood the risk and return structure. SABIC and SEC Sukuk issued in 2006 and 2007, lead managed by HSBC Saudi Arabia under the Capital Markets Law, were the first public Sukuk to be issued in Saudi Arabia. These Sukuk indicate huge potential market appetite for Sukuk as fixed income instruments against the unstable Saudi equity market that has been witnessing a steep decline since February 2006 (AlJaziracapital, 2010).

All debt instruments in the Kingdom have been issued under a general capital market regulatory framework according to Turki Al-Malik, Head of Authorization and Inspection at the CMA (Parker, Arab News, 2006). Nonetheless, it is imperative to have a specialized stand-alone regulatory framework for Sukuk in terms of securitization, Sukuk laws, trust laws and laws relating to the establishment of Special Purpose Vehicles (SPV). Moreover, the CMA needs to be proactive and promote Sukuk awareness by educating corporates about their value, feasibility, productivity, structures and risks.

The Saudi market has recently seen a proliferation of mergers and acquisitions, corporate clients, private equity/venture capital firms, and new commercial activities as a result of the regulatory reforms and rules pertaining to corporate finance rules. However, there is

no bond market in Saudi Arabia which is holding back the launching of Sukuk on a wide basis. This would eventually be imperative for an active primary and secondary bond and Sukuk market. This should however not hold back the Saudi Sukuk market as further issuances would eventually stimulate the recent trends and positive expectations of corporate Sukuk as a capital market instrument (Saudi Gazette, 2010).

Chapter Five

New Sukuk Structures

Introduction

Saudi Arabia is potentially a major and promising regional hub for Sukuk origination. There is a lack of Shariah-compliant fixed-income debt instruments in the Saudi market which further increases the attractiveness of corporate Sukuk as an asset class in the local capital market. Corporate Sukuk are financially attractive long-term financing instruments because they are liquid due to the fact that they can be securitized and are tradable.

Even though Sukuk issuers pay more for upfront fees for the structure, arranging, legal work and Shariah advisory, their overall cost of finance is on par with bank loans whether Islamic or conventional. The Sukuk market has been growing rapidly, with the exception of the period 2008-9 during the global financial crisis where issuance dropped to a near four-year low of \$0.9 billion. Pricing decreased by 18 percent in the final quarter of 2008 and decreased an additional 5 percent in mid-February (Dow Jones/Citigroup Sukuk Index (KPMG, 2010). Sukuk market fundamentals are the driving force behind the spate of issuance of riyal-denominated Sukuk in the domestic Saudi market (Chew, Bloomberg, 2011). There have been few corporate Sukuk issued in the Saudi debt market, which is a primary market where Sukuk-holders are likely to keep their Sukuk certificates to maturity in the absence of minimum secondary market trading (El-Qorchi 2005).

It is imperative for more Sukuk originations in the Saudi primary market, which would eventually be a basis for the development of a secondary and more liquid market, with a wider range of Sukuk structures and a wider base of investors. Identifying the most suitable Sukuk structures via innovative financial engineering for likely issuers is an important challenge facing the success of Sukuk in Saudi Arabia.

However, one of the key challenges is to obtain an appropriate Fatwa on a financial product certifying that it is Shariah-compliant. The rulings of the OIC Fiqh Academy, which is based in Jeddah, Saudi Arabia, in January 1981, has been largely respected by the Shariah committees of most Islamic banks, and Takaful (insurance) companies which supersedes any conflicting or contested Fatwas (Wilson, 2008). However, I think we should not limit Sukuk Fatwas as this might constrain innovation in Sukuk structures.

The Global Sukuk market faced a setback when a prominent Shariah scholar, Sheikh Muhammad Taqi Usmani, Chairman of the Shariah Board at the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, declared in November 2007 that 85% of Gulf Sukuk do not really comply with Islamic law. Although Shaikh Usmani did not identify the specific Sukuk issuances in his remarks, he disagreed with most of the Sukuk structures that underpin repurchase agreements as he thought that they violate a critical Islamic finance factor which is a profit and loss sharing arrangement. He claimed that most of the Sukuk Al Musharaka, Al Mudaraba and Al Istithmar structures in the Gulf are sold on the basis of a repurchase undertaking at face value at maturity, or in the event of default, duplicating a conventional bond structure (Oakley, FT, 2008).

I think this statement was not helpful for a new asset class like Sukuk still in its nascent development phase. Sheikh Usmani's interpretation of Islamic finance principles did not take into consideration other interpretations from different Islamic schools of law, and failed to understand that such a new asset classes is in significant need of support especially under the principle of Maslaha which is defined as the "unrestricted" public interest and Mursala, which means something of benefit for the community. The concept of Maslaha Mursala is permissible because of its broad benefit to the wider community, as long as they do not violate any Shari'a principle. This concept was implemented widely by the first Caliphs (The term caliphate "dominion of a caliph ('successor')") (from the Arabic خلافة or khilāfa)) and some Companions (Arabic: الصحابة -- from the verb صَحِبَ -- accompany, keep company with, associate with). Hence, the Maslaha Mursala concept is applicable to Sukuk, especially while they are in their early stage of development

(Dutton, 2002). “You must face the actual consequences of your investment,” Usmani argues (Reuters, 2007). This controversy has created confusion in the market over the Shariah compliance legitimacy of most of the existing Sukuk.

Sukuk are frequently categorized to be either one of two kinds: asset-based, where the credit risk of the Sukuk is linked to the issuer, or asset-backed, where the credit risk is linked to the underlying assets. However, the Shariah perspective favours the latter (Ravalia 2008). Sukuk structures in Saudi Arabia are also underdeveloped due to the fact that the ownership of the underlying asset, pooled in a special purpose vehicle (SPV), cannot be securitized for a true sale to investors via a pool of assets due to the absence of a suitable legal infrastructure system.

Therefore, Sukuk holders may not have any more legal rights than similar conventional bonds in case of default. In this case, some “courts may consider Sukuk holders to have contractual rights as opposed to proprietary rights and as a result rank them as creditors rather than equity holders,” said Muneer Khan, partner and head of Islamic finance at law firm Simmons and Simmons (Khan, 2009). As a result, Sukuk financial engineering structures are facing an unprecedented contest in terms of their viability, especially when threatened with a default or restructuring, as is the situation for regional Sukuk affected by the 2008-9 global economic downturn.

Identifying Suitable Sukuk Structures

Sukuk structuring has been witnessing a significant evolution and growth due to the increasing demand by investors and issuers. Most Sukuk structures evolve around the true spirit of Islamic financing principles, which is that the Sukuk-holder must have an undivided ownership interest in a particular asset and is therefore entitled to the return generated by the asset. Also, the Shariah bans trading of pure debt receivables more than 30 percent of the underlying assets, except at par. This is the uniqueness of Sukuk as an investment instrument (Archer and Abdel Karim, Islamic Finance, 2004).

Most Sukuk are usually structured where the Sukuk holders are financially taking the credit rating and risk of the corporate or sovereign issuer, and receive their return from the performance. Thus, as Sukuk are supposed to be asset backed securities, they are often structured as asset-based and not asset-backed securities (Allen & Overy 2008).

However, a standard Sukuk structure requires an acquisition of entitlement or a property asset through a special purpose vehicle (SPV). This Sukuk structure is relatively similar to the conventional asset-backed securities that provide investors with ownership in a specified underlying asset, found on the balance sheet of the issuing company. Sukuk issuance is obliged to be for the funding and/or production of assets.

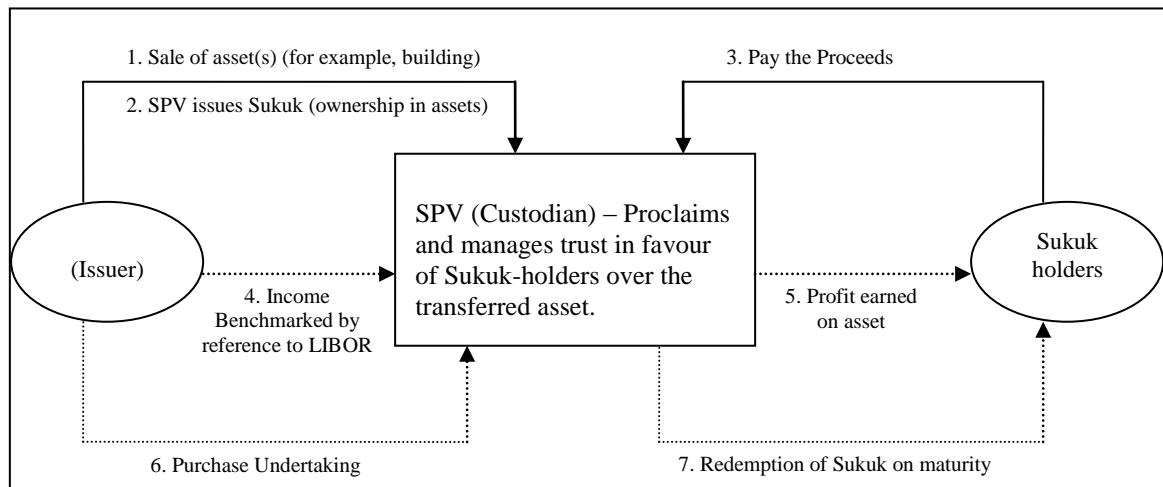
Sukuk structuring adopted parts of the conventional securitization process involving an SPV for the purpose of the enhancement of creditworthiness for the security of the investment in addition to limiting investors' exposure. Also the Sukuk pricing mechanism is based on comparisons with that of equivalent conventional financing instruments (Zaidi 2007). However, Sukuk are subject to more restrictions such as financing income capitalization up to a 30 percent maximum debt as percentage of the issuer's total assets on financing that could add an extensive value by minimizing the over-leveraging risk that has been the main cause for the recent global financial crisis.

SPVs also are evolving into independent trust companies which fund their activities by issuing Sukuk. The SPV issues Sukuk and the Sukuk-holders enjoy a return based on the income generated by the underlying assets, as they are assuming the credit risk of the underlying lessee (See figure 5.1). The purpose is basically to assign a trustee to be employed by the originator as a liaison between originators and beneficiaries to protect the interest of both stakeholders in the event of an issuer or borrower default. Under the Shariah, the issuer must remain the trustee. The fact that the SPV does not have the required experience to manage the assets and the transaction is another reason to create independent trust companies (Staff Writer, Islamic Finance Asia, 2011). In spite of that, the most popular Sukuk structure in recent years is the Sukuk Al-Ijarah which basically entails the leasing of real assets, mostly for developed real estates, and payments are

generated from rents, with an undertaking by the issuer to buy back the assets at nominal value by the end of the rental agreement.

The reason behind the rapid growth of the Ijarah Sukuk is the free risk the issuer is offering to the investors without reflecting the genuine basics of Islamic finance by engaging in the production of a value added asset via taking some acceptable risk for most stakeholders.

Figure 5.1 Standard Sukuk Structure

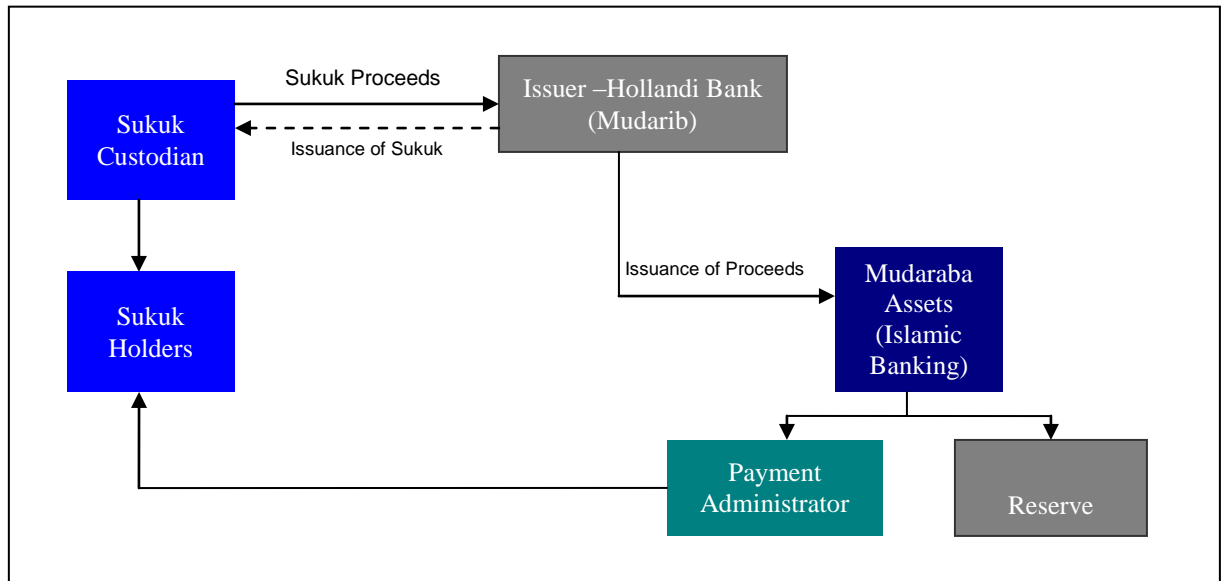


Identifying the suitable underlying assets to be securitized is an important challenge during the Sukuk structuring process. Furthermore, these assets, either tangible or intangible, must be Shariah-compliant and be able to generate a sustainable return. Recent Saudi Sukuk issuers showed true innovative spirit in identifying asset pools for securitization which hitherto have not been used even in the conventional bonds and securitization, this, despite a banking operating environment characterized by religious conservatism. These asset pools have included petrochemical marketing contracts and pools of tariff receivables due on electricity meters.

In the SABIC and SEC pool of Sukuk assets, they comprise investment in the rights to receivables due on petrochemical contracts and tariffs due on identified bundles of

electricity meters. I think it would be prudent to securitize an underlying asset with a return (cash flow) over securitizing tangible assets without a return.

Figure 5.2: Saudi Hollandi Bank Sukuk Structure



Source: (Author and Colleague, 2004)

Saudi Hollandi Bank Sukuk Structure Highlights

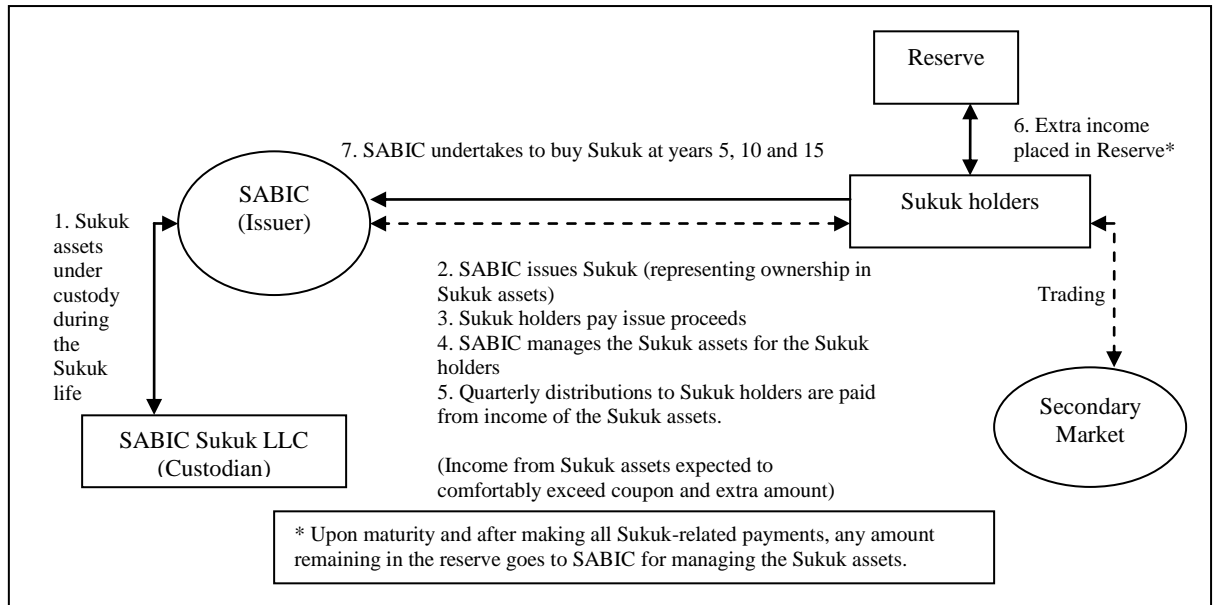
The Saudi Hollandi Bank (SHB) has been issuing Sukuk (See figure 5.2) since 2004. It is the first bank in the Middle East to issue Sukuk. Its latest Sukuk was the first tranche of a SAR 1.5 billion Tier-II Sukuk Programme issued in December 2009, the proceeds of which were used to boost its Tier 1 Capital.

"The Kingdom is one of the fastest growing markets in the world for Islamic banking and finance." SHB's Chairman, Mubarak Al-Khafrah commented. In addition, Geoff Calvert, SHB's Managing Director explained, "the SAR 775 million Mudaraba Sukuk is a Shariah-compliant follow-up to the Bank's first Tier-II capital bond for SAR 700 million that was issued in 2004." He added that, "SHB's Sukuk issue is the first by a bank in the Middle East and is expected to set the standard for future Shari'a-compliant debt issues in the Kingdom and the region." (Al-Khafrah and Geoff, 2009)

The SAR 775 million Mudaraba Sukuk are private placements with a 10-year maturity, and the investors have the option to call it at the end of the first years, based on variable rate of return paid to investors on bi-annual basis with the principle amount to be returned as a bullet payment on maturity. Below are the details of the SHB's Mudaraba Sukuk Structure:

- Saudi Hollandi Bank as Mudarib enters into a Mudarabah agreement with Sukuk Holders and issues Sukuk.
- Under the Mudaraba arrangement, the Mudarib could shore up the bank's capital to develop its Shariah-compliant services and products with the option to consolidate Mudaraba Sukuk proceeds with its existing Shariah-compliant business.
- The Sukuk Holders and the Mudarib agree to share in the return generated by the Mudaraba business in pre-stipulated percentages (e.g. 60:40).
- Bi-annual distributions to the Sukuk holders are paid from the income of the Sukuk assets.
- Extra income placed in reserve to fund any default in any recurring distribution and for any principal loss at maturity or early termination in the event of default.
- The cumulative face value of the Mudaraba certificates payable upon the redemption of the Mudaraba certificates by the issuer upon the event of Expiry Date/Event of Default Date, less any loss relating to the Mudaraba assets not covered by the funds (if any) outstanding to the credit of the Reserve.

Figure 5.3: Saudi SABIC Sukuk Structure



Source: (Islamic Finance News, 2006)

SABIC Sukuk Structure Highlights

SABIC issued SABIC Sukuk I, II and III in 2006, 2007 and 2008 respectively, with a distinctive Sukuk structure (See figure 5.3) had to be developed for SABIC's Sukuk Al-Istithmaar (investment). The main challenge of the SABIC Sukuk was that SABIC as a holding company has only equity assets in various affiliate petrochemical companies. The securitizing of limited rights and obligations in certain SABIC petrochemical marketing contracts is indeed a first in the global Sukuk industry.

In addition, any surplus income is diverted into a reserve fund as a cushion to shield Sukuk holders in the unlikely event that any periodical net income would fall below a particular amount. Also, the fund would be used to pay, every 5 years throughout the 20-year tenor of the Sukuk, 10% of the face value of the Sukuk for the purpose of 40% amount to be fully paid for the Sukuk subscription at years 5, 10 and 15 with variable rate of return paid to investors on a quarterly basis (SIBOR benchmarked).

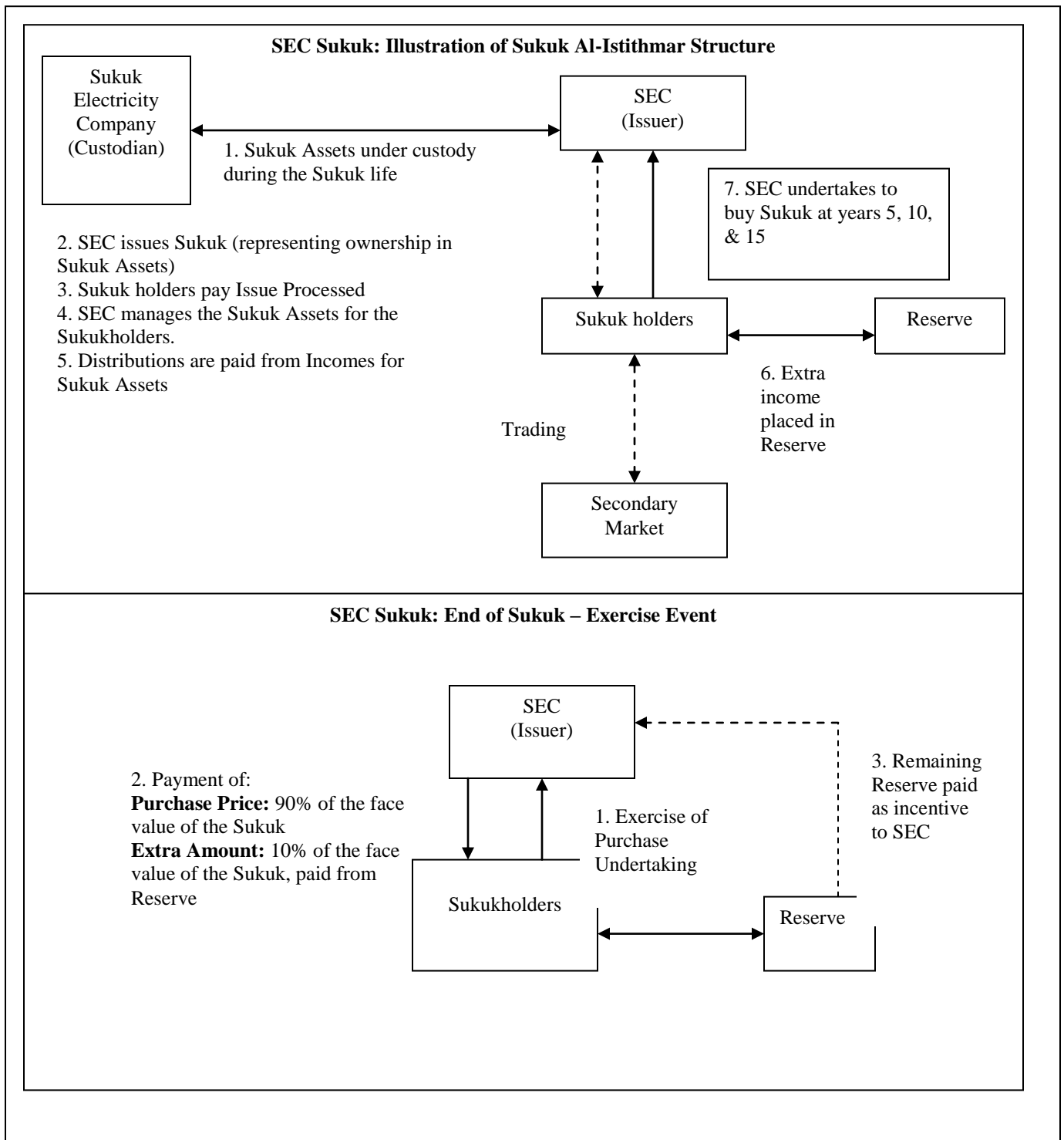
At the end of the Sukuk tenor, whether 20-years or earlier, if the Sukuk is purchased by SABIC prior to this, then any remaining balance in the reserve is paid to SABIC, thus

providing a strong incentive to the company to improve its marketing performance. In addition, SABIC provides Sukuk holders with a purchase undertaking, under which it undertakes (as direct SABIC credit risk) to purchase the Sukuk for a specific amount on each date (Kamal & Al Sudairy, 2006):

- SABIC Sukuk LLC – Custodian
 - Sukuk assets under custody during the Sukuk life.
 - Contractually required to hold Sukuk Assets as Custodian for the benefit of the Investors,
- Reserve:
 - Built-up in early years,
 - Distribute as follows:
 - Shortfalls,
 - Extra Amount (10% face value) every 5 years,
 - At the end of the Sukuk, as an incentive fee to SABIC.
- SABIC obliged to purchase Sukuk at investor option
 - Investors individually have an irrevocable right to “Put” at year 5. No Issuer “Call”
- Over-collateralized Reserve provided sufficient coverage:
 - In case of defaults, the collateral redeems the Sukuk in full and the excess reserve (over-collateralization) is allocated to the payment of the residual (or junior or subordinated) portion. Hence, over-collateralized reserve is expected to build up more than required amount for 5th year payment in early years.

SEC Sukuk Structure Highlights

Figure 5.4: Saudi SEC Sukuk Structure

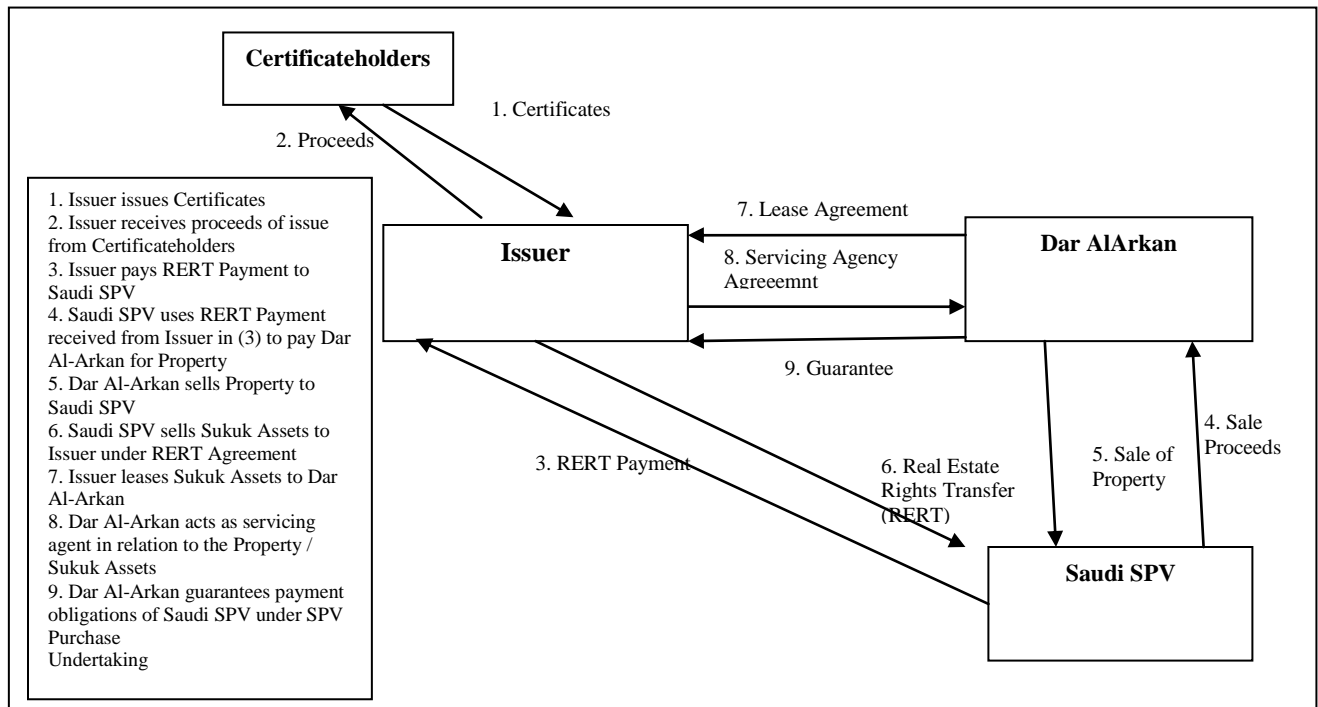


Source: (HSBC, 2007)

Saudi Electricity Company (SEC) issued SEC Sukuk I and II in 2007 and 2008 respectively (See figure 5.4). Each of the Sukuk has a tenor of 20 years with a variable rate of return paid to investors on a quarterly basis:

- Sukuk Electricity Company – Custodian
 - Achieves effective segregation of Sukuk Assets from SEC’s own assets,
 - Contractually required to hold Sukuk Assets as Custodian for the benefit of the Investors,
 - Wholly-owned by SEC, but subject to annual statutory audit.
- Reserve:
 - Built-up in early years,
 - Distribute as follows:
 - Shortfalls,
 - Extra Amount (10% face value) every 5 years,
 - At the end of the Sukuk, as an incentive fee to SEC.
- SEC obliged to purchase Sukuk at investor option
 - Investors individually have an irrevocable right to “Put” at year 5. No Issuer “Call”
- Over-collateralized Reserve provided sufficient coverage:
 - Expected to build up more than required amount for 5th year payment in early years.
- Meter reading – extremely stable:
 - Default rate negligible: electricity is a fundamental need, low cost and no alternative supplier,
 - Investors protected in case of change to Tariffs or change in regulatory framework,
 - Costs are clearly identified and subject to cap,
 - Hence, Sukuk Assets comprise extremely stable income source.
- SEC Commitment:
 - Incentivised to prevent shortfall in payments (disputes, board level support).

Figure 5.5: Dar Al Arkan Real Estate Sukuk Structure



(Dar Al Arkan Sukuk, Offering Circular, 2007)

Dar Al-Arkan Highlights of the Structure

Dar Al-Arkan Real Estate Development Company (DAAR) issued a Sukuk in 2007 (See figure 5.5). The Features include (Dar AlArkan Sukuk Offering Circular, 2007):

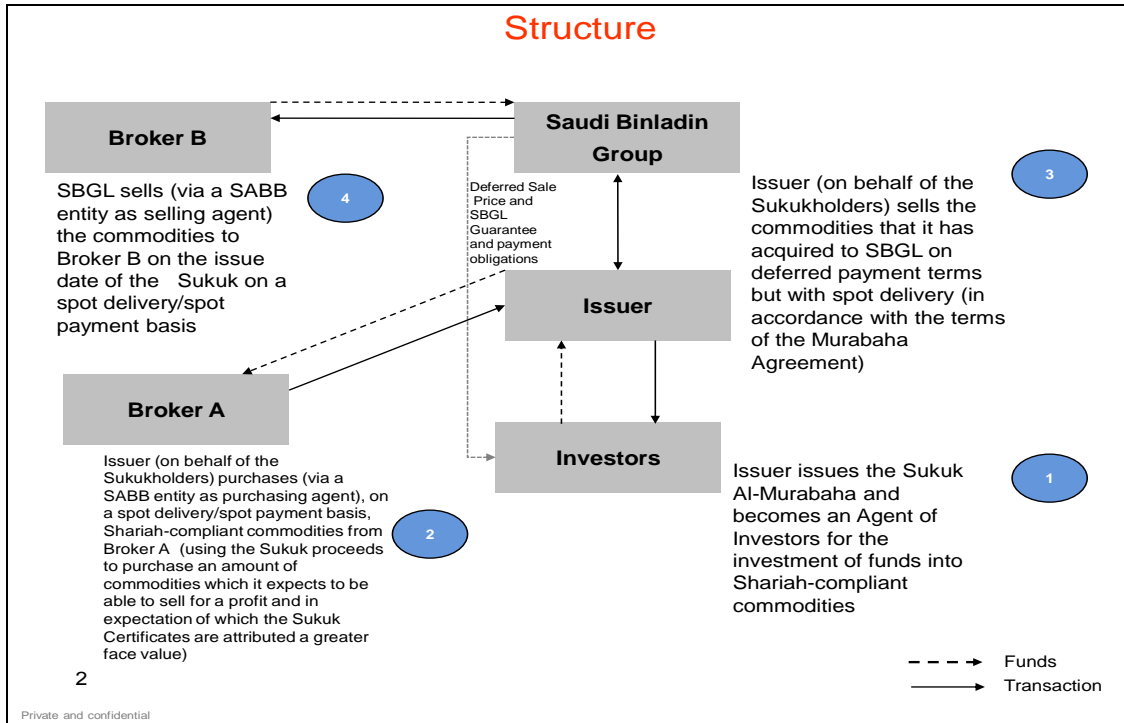
1. Dar Al-Arkan International Sukuk Company, a limited liability company incorporated in the Cayman Islands (the **Issuer**).
2. The issued share capital of the Issuer is US\$250 consisting of 250 shares with a nominal value of US\$1 each. All of the issued shares are owned by Maples Finance Limited on trust for charitable purposes pursuant to a declaration of trust.
3. Sukuk Al Asoul Co. Ltd., a limited liability company incorporated in the Kingdom of Saudi Arabia (**Saudi SPV**).
4. The authorised share capital of Saudi SPV is SR500,000 consisting of 500 shares with a nominal value of SR1000 each. 125 of the shares are owned by Abdullah Bin Saleh Abdulaziz Al-Saudi and 375 of the shares are owned by Abdulaziz Bin Mohammed Bin Abdulrahman Al-Kassem each of whom is independent of, and unrelated to, Dar Al-Arkan.
5. Dar Al-Arkan (in such capacity, the **Lessee**) will enter into a lease of the Sukuk Assets (as defined below) with the Issuer (in such capacity, the **Lessor**), pursuant to a Lease Agreement (as defined below).

6. Dar Al-Arkan (in such capacity, the **Obligor**) shall execute an Obligor Purchase Undertaking (as defined below) in favour of Saudi SPV, pursuant to which the Obligor will undertake to, in certain circumstances, purchase the Property from Saudi SPV.
7. Dar Al-Arkan (in such capacity, the **Guarantor**) shall grant a third party guarantee (the **Guarantee**) dated the Closing Date in favour of the Issuer pursuant to which Dar Al-Arkan shall irrevocably and unconditionally guarantee the payment obligations of SPV Obligor under the SPV Purchase Undertaking.
8. Sukuk Al Asoul Co. Ltd. (in such capacity, the **SPV Obligor**) shall execute a SPV Purchase Undertaking (as defined below) in favour of the Issuer, pursuant to which the SPV Obligor will undertake, in certain circumstances, to purchase the Sukuk Assets from the Issuer.
9. Under the terms of the Servicing Agency Agreement, Dar Al-Arkan (in this capacity, the **Servicing Agent**) will, amongst other things, be responsible on behalf of the Issuer for the performance of and/or payment in relation to, Major Maintenance and Structural Repair, Proprietorship Taxes (including zakat) and Insurances (each as defined herein, see **Trust Assets**) in respect of the Property and/or Sukuk Assets and as provided in the Servicing Agency Agreement (the **Services**).
10. The Issuer will act as trustee in respect of the Trust Assets (as defined below) (the **Trustee**) for the benefit of Certificateholders in accordance with the Declaration of Trust and the Conditions.
11. Deutsche Bank AG, London Branch (the **Transaction Administrator**) shall be appointed by the Trustee as agent and representative of the Certificateholders. The Issuer will act on the instructions of the Transaction Administrator (acting in its capacity as agent for the Certificateholders) in respect of certain matters specified in the Transaction Administration Deed in relation to the Trust Assets.
12. Maples Finance Limited (the **Administrator**) will perform certain services necessary and appropriate for the management of the business of the Issuer in and from the Cayman Islands.
13. Arab National Bank (the **Custodian**) shall be appointed by the Issuer and Saudi SPV as agent and representative of the Certificateholders, under the terms of the Covenants Agreement (as defined below), to hold the title deeds to the Property, and any Substitute Property (each as defined below).
14. Saudi SPV shall, pursuant to a purchase agreement dated the Closing Date (the **Purchase Agreement**), purchase from Dar Al-Arkan the title to certain land and developments within the Shams ArRiyadh Zone 1, Shams ArRiyadh Zone 2, the Al Qasr Project and Al Maseef compound, each located on the outskirts of Riyadh (the **Property**).
15. Saudi SPV shall, pursuant to a real estate rights transfer agreement dated the Closing Date (the **RERT Agreement**), sell to the Issuer rights and interests in and to the Property allowing the Issuer to bear the risks and rewards relating thereto. The Issuer will use the proceeds of the issuance of the Certificates to pay the aggregate purchase price payable by the Issuer to Saudi SPV for the Sukuk Assets pursuant to the terms of the RERT Agreement.

16. The Sukuk Assets shall initially comprise certain rights and interests over the Property (as more particularly described in *Sukuk Assets* and the Valuation Reports at Appendix 2) including the right to appoint a servicing agent in relation to the Property. The Property has at the dates contained in the Valuation Reports been valued at SR3,824,378,793 (US\$1,019,834,344) by J.A.J. Consultants LLC as set out in the Valuation Reports at Appendix 2.
17. The Property and the Sukuk Assets may in certain circumstances be substituted in whole or in part at the option of Dar Al-Arkan on any Periodic Distribution Date, pursuant to the terms of the Property Substitution Undertaking and the Sukuk Assets Substitution Undertaking.
18. Under the terms of a property substitution undertaking dated the Closing Date granted by Saudi SPV to Dar Al-Arkan (the **Property Substitution Undertaking**), Saudi SPV undertakes to purchase a substitute property (the **Substitute Property**) from Dar Al-Arkan if so requested by Dar Al-Arkan on each Periodic Distribution Date in consideration of a transfer to Dar Al-Arkan of all or any part of the Property provided always that:
 - (a) at such time, no Dissolution Event (as defined below) has occurred and is continuing;
 - (b) the Substitute Property is a similar asset, with an equivalent value to the value of the Property as set out in the Valuation Reports at Appendix 2. The valuation of the Substitute Property shall be as shown in a valuation report carried out not more than 3 months prior to the date of the transfer for the substituted property issued by a firm of property surveyors or valuers of international repute (selected by Dar Al-Arkan with the consent of the Issuer) and on the same basis as the original Valuation Report of the Property to be substituted; and
 - (c) any costs and expenses (including legal fees, notarial, property registration fees and taxes, if any) to effect the substitution must be paid in full by Dar Al-Arkan.
19. Under the terms of a sukuk assets substitution undertaking dated the Closing Date granted by the Issuer to Saudi SPV (the **Sukuk Assets Substitution Undertaking**), the Issuer undertakes to purchase a substitute sukuk asset (the **Substitute Sukuk Asset**) from Saudi SPV if so requested by Saudi SPV on each Periodic Distribution Date in consideration of a transfer to it of the Sukuk Assets. The Substitute Sukuk Asset will comprise Saudi SPV's rights and interests arising out of the Substitute Property. On any such substitution, the Lessee will confirm that Certificateholders will not in any way be materially prejudiced by such substitution.
20. The Lessee undertakes and agrees, in the following Rental Adjustment Period (as defined below), to lease the Substitute Sukuk Assets in accordance with the Lease Agreement (see below).
21. Under the terms of the lease agreement dated the Closing Date between the Issuer and Dar Al-Arkan (in such capacity the **Lessee**) (the **Lease Agreement**), the Lessee leases the property comprising the Sukuk Assets for a term of 5 years comprising twenty consecutive lease periods of three months (each, a **Rental**

- Adjustment Period**), the first commencing on the Closing Date and the last ending on the Scheduled Redemption Date, unless terminated earlier following an Event of Default, a Change in Circumstances or a Total Loss (each as defined in the Lease Agreement).
22. The rental payment under the Lease for each Rental Adjustment Period (the **Rental**) will equal the Periodic Distribution Amounts payable on the Periodic Distribution Date applicable to such Rental Adjustment Period (each as defined herein).
 23. Under the terms of the Servicing Agency Agreement, dated the Closing Date between the Issuer, as the Lessor of the Sukuk Assets, and the Servicing Agent (the **Servicing Agency Agreement**), the Servicing Agent will, amongst other things, be responsible on behalf of the Issuer for performing the Services.
 24. The Obligor shall execute a purchase undertaking (the **Obligor Purchase Undertaking**) in favour of Saudi SPV. Pursuant to the Obligor Purchase Undertaking, the Obligor shall undertake to purchase the Property or Substitute Property at the Exercise Price (as defined below) following the issue of a notice from Saudi SPV (the **Obligor Exercise Notice**).
 25. SPV Obligor shall execute a purchase undertaking (the **SPV Purchase Undertaking**) in favour of the Issuer. Pursuant to the SPV Purchase Undertaking, SPV Obligor shall undertake to purchase the Sukuk Assets at the Exercise Price following the issue of a notice from the Issuer (the **SPV Exercise Notice**).
 26. The **Exercise Price** payable by the Obligor (pursuant to the issue of an Obligor Exercise Notice) and SPV Obligor (pursuant to the issue of an SPV Exercise Notice) shall be the aggregate of US\$1,000,000,000 plus any due but unpaid Periodic Distribution Amount.
 27. The obligations of the Obligor under the Obligor Purchase Undertaking, the SPV Obligor under the SPV Purchase Undertaking and the Guarantor under the Guarantee constitute direct, unconditional and unsubordinated obligations of each of those parties which at all times rank *pari passu* with all other unsecured and unsubordinated obligations, save for such obligations as may be preferred by provisions of law that are both mandatory and of general application.
 28. The Guarantor shall grant the Guarantee in favour of the Issuer pursuant to which Dar Al-Arkan shall irrevocably and unconditionally guarantee the payment obligations of SPV Obligor under the SPV Purchase Undertaking.
 29. Under the terms of a covenants agreement between the Issuer, Saudi SPV, shareholders of Saudi SPV and the Custodian (the **Covenants Agreement**):
 - (a) Saudi SPV undertakes to, among other things, act in accordance with the instructions of the Issuer and/or the Transaction Administrator in relation to the Transaction Documents to which Saudi SPV is a party;
 - (b) the Custodian agrees to hold the title deeds to the Property and any Substitute Property to the order of the Issuer and Saudi SPV; and
 - (c) Saudi SPV and the shareholders of Saudi SPV agree to sell the Property (or any Substitute Property) held by Saudi SPV, to satisfy any obligations of Dar Al-Arkan (in any capacity) or Saudi SPV (in any capacity) owing under any of the Transaction Documents promptly following instructions received by it by or on behalf of the Issuer.

Figure 5.6: Bin Laden Group Al-Murabaha Sukuk Structure



Source: (Baker McKenzie "Bahrain", 2010)

Highlights of Bin Laden Sukuk Structure

According to the Information Memorandum (2010) of Saudi Bin Laden Group the proceeds from the Sukuk issuance will be invested by the issuer on behalf of the sukuk holders in acquiring a Shari'a-compliant commodity (the Commodity, as defined below) and selling the same to Saudi Binladin Group Limited as purchaser under a Murabaha transaction (the "Murabaha Arrangements") as follows:

1. On the Issue Date, the Issuer shall issue Sukuk, the terms of which are described in the Conditions as set out in this Information Memorandum and attached to each Sukuk Certificate as set out in figure 5.6 (Form of Global Certificate) to the Declaration of Agency. In respect of the proceeds of issue of the Sukuk, the Issuer shall act as agent of the Sukukholders (wakeel).
2. Pursuant to the terms of the Sukuk Documents, the Issuer shall enter into a murabaha agreement (the "Murabaha Agreement") in its capacity as seller, on behalf of the Sukukholders, with Saudi Binladin Group Limited acting in its capacity as purchaser (the "Purchaser") and SABB Securities Limited as the Sukukholders' Agent.

3. Under the Buying Agency Agreement, the Issuer will appoint SABB Securities Limited to act on its behalf as its undisclosed buying agent (the "Buying Agent") in the purchase of a Shariah-compliant commodity (the "Commodity") from an Approved Broker at a purchase price (the "Cost Price") on the Issue Date upon having received a purchase order (the "Purchase Request") from the Purchaser under the Murabaha Agreement. In the Purchase Order, the Purchaser will irrevocably undertake to purchase the Commodity from the Issuer (on behalf of the Sukukholders) at a sale price which is equal to the face value of the Sukuk (the "Deferred Sale Price") payable to the Sukukholders on a deferred payment basis (in a lump sum) on 12 April 2011 (the "Maturity Date").
4. The proceeds received from the Sukukholders shall be used by the Issuer (acting through the Buying Agent) to fund the Cost Price of the Commodity.
5. Upon purchasing the Commodity from the Approved Broker on the Issue Date, the Issuer shall, pursuant to the Murabaha Agreement, sell the Commodity to the Purchaser at the Deferred Sale Price payable on the Maturity Date. Any payments due by the Purchaser under or pursuant to the Murabaha Agreement or in relation to the Sukuk shall be made to the Payments Administrator for the account of the Sukukholders.

Upon completion of the sale of the Commodity from the Issuer to the Purchaser, the Purchaser shall sell the Commodity either directly or through a selling agent to an Approved Broker for cash consideration on spot basis.

Sukuk as a Substitute for Corporate Bonds and Floating Rate Notes

Sukuk as Shariah-compliant financing instruments have gained substantial recognition in the last decade for both corporate and sovereign issuances as a result of a surging Islamic banking profile. Not surprisingly, Sukuk have emerged as Shariah-compliant alternatives to conventional bonds. Furthermore, Sukuk can now “compete on their own merits in terms of efficient products and services in the global marketplace”, according to Dr. Muhammed Al-Jasser, Governor of SAMA. As such, more Saudi companies are now interested in Sukuk origination after decades of shunning conventional corporate bonds and Floating Rate Notes because they are not Shariah-compliant (Arab News, 2009).

Since its inception in 2000, the total volume of the first three Sukuk amounted to USD336 million and this figure was boosted by the end of 2007 to reach a total global

Sukuk outstanding of USD61 billion. These comprised mainly corporate issuances. This increase is mainly due to increased demand by investors, and may indicate the growing preference of Sukuk over corporate bonds and Floating Rate Notes at least in the Middle East and South East Asia (Wilson, 2007).

However, as part of the fixed income securities, Sukuk issuance decelerated in 2008-9 due to the global financial crisis. The acute global liquidity crisis, widening spreads, and low level of investors' confidence have impacted on the global fixed income markets, whether conventional or Islamic. However, a recovery for the Sukuk market during the second half of 2009, 2010 through to 2011 has been remarkable and it is expected to see more deals in the pipeline. The prospects for Sukuk issuance in Saudi Arabia is promising as more potential issuers are exploring the possibility of issuing Sukuk (S&P's, 2009). For years companies have been ignoring corporate bonds as they consider them to be non-Shariah compliant, and have instead engaged in bank and syndicated loans.

Though most of the corporate Sukuk issuances have been in Malaysia and the United Arab Emirates, it is the Kingdom that holds out huge opportunities for Sukuk origination for the next decades or so. In the petrochemical sector, the Kingdom has announced a SAR 1,500 billion investment programme for the period 2009-2014, which involves new projects, surrounding infrastructure and upgrades to existing facilities. At the same time, the Jeddah Municipality in 2009 announced a SR35 billion Urban Regeneration programme. Both will involve the private sector and will include financing options comprising debt and Sukuk (SAGIA, 2009).

According to Professor Rodney Wilson (2007), the potential for corporate Sukuk in Saudi Arabia is enormous. However, it is crucial for Sukuk to develop a distinct financial characteristic away from conventional securities, but this would depend on the progress of Sukuk innovation based on an attractive and competitive risk/return for portfolio investors (Wilson, 2007).

The constraints by banks on granting loans to the private sector during the 2008-9 global financial crisis is a further reason for developing a Shariah-compliant debt market with Sukuk as the leading long-term investment asset class in Sukuk in Saudi Arabia. Saudi companies have been scrambling to secure a sustainable source of funding other than bank loans, as banks are hesitant to give up some of their liquidity amid a global market suffering from low levels of confidence. Also banks were concerned that a severe liquidity shortage in the local market would expose them to high loan-to-asset ratios (FT, 2010).

In spite of this, the liquidity of the local market is significant as underlined by the continuing availability of industrial and infrastructure finance in Saudi Arabia. Sukuk would offer companies in Saudi Arabia more options other than bank loans, which are mostly short-term financing, or government funds that also are vulnerable to the volatility of government support which depends on oil revenues.

One of the strategic objectives for the Saudi government and private sector is to diversify the source of financing for the expansion of the private sector through the development of the equity and debt markets. It is vital to create a broader financing base and options to reduce the role of the government in the provision of financing.

Sukuk can be a viable alternative in this respect. But the Saudi Sukuk market needs to develop substantially in terms of critical mass of issuances, types of Sukuk, a wider investor base, the innovation of new asset pools, the development of a secondary market and the requisite regulatory and legal framework.

Sukuk issuance in the Saudi Arabian market in 2011 has been very successful due to their oversubscription by investors. The Saudi Aramco Total Refining and Total S.A. of France (SATORP), issued its debut Sukuk of the three-year for SAR3.75 billion following the Saudi International Petrochemical Company (Sipchem) issuance of a SAR1.8 billion (Gazette, 2011). Both issuances were over-subscribed 3.5 times.

The Sukuk issuances by AlJazeera Bank, SIPCHEM and SATORP in 2011 support the fact that there is a great potential for corporate Sukuk origination in Saudi Arabia. In recent years, local and global banks diminished their commitments to provide financing to Saudi infrastructure, petrochemical and real estate projects in the aftermath of the 2008-9 global financial crisis which helped to increase demands to develop Sukuk asset class as an alternative to the dominant bank loans (Platt, Global Finance, 2011).

Sukuk is also ideal for financing real estate transactions in the Kingdom, where the demand and supply dynamics of the market is imbalanced due to the fact that there is no mortgage system that would guarantee a sustainable cash flow. Therefore, Sukuk could provide long-term financing options for the real estate companies until their projects materialize, and subsequently capitalize on them by securitising them in the market and generating a cash flow. Most Sukuk structures are appropriate for most of the investors especially fund managers, insurance companies and financial institutions. Saudi Arabia was the least active amongst the GCC issuers with only 2 issues raising SAR 750 million and SAR 7billion respectively (Markaz 2009).

Companies Desire Corporate Sukuk or Bonds over Banks Lending and/or Equity Finance

Most companies desire to issue or sell equity in periods when stock prices are rising to raise funding to finance their expansion and to take advantage of the high stock prices. However, companies avoid issuing equity when the market is down and investors are bearish. Issuing equity under these conditions would suppress earnings and consequently the stock price, for that reason, companies will issue equity only when they have the same expectations as investors for an upturn in share price with high valuation and in a flourishing equity market. As such, equity issuance will abound when stock prices are high, and debt issuance will abound when stock prices are low (QFinance, 2011).

Equity issuance is usually followed by increased capital expenditure and usually through a listing of a company, or an IPO or private placement. Firms prefer to avoid issuing equity because investors expect managers to issue equity when the firm is overvalued.

But investors are only willing to buy equity at a discount. As a result, companies resort to issuing debt whenever possible. According to the trade-off theory, each firm should have an optimal leverage ratio between debt and equity. When the value of equity goes up, the leverage ratio goes down. Firms should then increase debt to balance the ratio (Deloitte, 2011).

However, in the Saudi market the opposite is happening where companies are issuing additional equity as its price goes up. That is why companies favour Sukuk or bonds over equity finance, as the burden of issuing more equity will require making more returns (Dittmar & Thakor, 2006).

Nonetheless, if companies choose to issue debt they would only be able to finance the targeted project with the allocated Sukuk and would restrict managers to use the raised debt for the specified project. Issuing equity on the other hand, does not restrict managers' decisions. The value of equity depends on whether managers and investors agree on the profitability of a project. But if investors disagree with the investment equity issuance they will dump the share, affecting it negatively and this will suppress the stock price if they believe that the investment is not profitable. Nonetheless, developing the long-term debt financing culture among Saudi firms needs to encompass new practices in the Saudi capital market (Watheeqa, 2010).

Bank credit is an important source of capital that fuels local economic growth and development. Small and medium businesses take loans from banks to start new activities or expand their existing operations. This will help create new jobs and the expected cash flow will expand the economy. In Saudi Arabia, most bank loans are represented by consumer, commercial and industrial loans as most banks favour short-term loans (maturity of one year or less) (Ramady, 2005).

Banks lending in Saudi Arabia is closely regulated because it is the centre of risk for most banks and as it has less risk involved, as banks prefer short-term lending over long-term lending. Also, bank loans could be difficult to obtain especially during a downturn

economy as banks become over-cautious and are reluctant to lend, as happened during the 2008-9 global financial crisis. In the case of Saudi Arabia, many businesses especially family-owned businesses were facing major liquidity problems (Sfakianakis, Al Hugail, Merzaban, Banque Saudi Fransi, 2010).

The fact that most banks lending in Saudi Arabia is short-term means that the companies which borrow to finance long-term projects face an asset-liability mismatch on their balance sheet. As a result, it is imperative for long-term financing instruments such as Sukuk to meet the spiralling demand. With the new mortgage law expected to be adopted imminently in Saudi Arabia, banks will need to offer long-term financing for mortgages and the like. At the same time, Sukuk can give companies seeking to raise capital via the debt market, the capacity or opportunity to decide on the conditions over which they want to borrow through a Sukuk issue (Jadwa 2009).

Yet many Sukuk stakeholders argue that one of the great challenges facing the corporate Sukuk market in Saudi Arabia is the non-existence of a sovereign Sukuk for benchmark purposes. They think that this is distorting Sukuk pricing significantly and holding back the development of a potentially huge market. They claim that corporate Sukuk issuers are in desperate need for the creation of a sovereign benchmark price and a yield curve (derived from the relationship between the interest rate and maturity of a bond) for the Kingdom. "A sovereign issue would be welcome as a way of establishing a benchmark," said Howard Handy, Chief Economist at Samba Financial Group in Riyadh (Reuters 2009). However, I think that this pretext should not be used to undermine the constructive possibilities for corporate Sukuk in Saudi Arabia. After all there are many quasi-sovereigns Sukuk, such as the SABIC and SEC issuances, which can be used as a pricing benchmark alternative to the sovereign yield.

Furthermore, in October 2011, the Finance Minister of Saudi Arabia, Dr. Ibrahim Al Assaf, stated that Saudi Arabia is considering whether to issue Islamic or conventional bonds to help fund specific projects which would be financed from the receipts of such projects such as airports with possible government guarantees. AlAssaf said debt issuance

to help cover expanded budget spending was not on the cards. The financial market in Saudi Arabia has welcomed such comments with the expectation that the government could help grow the debt market by supporting its public entities to issue debt instruments. According the International Monetary Fund, the Saudi government debt is as low as 7.1 percent of GDP in 2011, enabling the government to easily tap or help is entities tap the debt market without concern of being over-leveraged (AlSharif, Reuters, 2011).

The Choice between Corporate Sukuk or Bonds?

Saudi corporate bonds for the last decade has been limited to banks issuing conventional Euro Medium Term Notes (EMTN) programmes in the global market for their dollar medium-term funding needs. National Commercial Bank (NCB), SABB Bank (previously known as The Saudi British Bank), Samba Financial Group, Arab National Bank (ANB) and Riyadh Bank have all issued global EMTN programmes. However, in most of these cases issuances by the Saudi banks were mainly targeting international capital markets for dollar fund raising as the local market demand was mainly for Sukuk. Nevertheless, against a growing demand and preference for Sukuk, conventional corporate bonds in Saudi Arabia have decreased substantially in the local debt market (El Dada and Nizam, Audi Capital, 2009).

Most Saudi banks are over-dependant on their funding requirements through short-term funding sources, mainly in the form of stable customer deposits and interbank lending. Prior to the 2008-9 global financial crisis, such sources were a stable source of funding, but with the current global financial regulatory requirements, banks liquidity could be adversely affected and it may be required to seek funding from expensive resources, causing an adverse impact on banks' businesses, financial conditions and operations. Therefore, issuing more debt instruments is a critical step forward for Saudi banks to ensure a stable medium and long-term source of funding with reasonable cost via Sukuk and bonds in the nascent local debt market (Ramady, 2005).

Due to a substantial market driven demand on most Sukuk offerings with a bid-to-offer ratio of 3-to-4 times, Saudi banks can capitalize on Sukuk by issuing medium term Sukuk instruments in order to boost their Tier II capital in line with the requirements of Basel II. Sukuk can be used by Saudi Banks to strengthen their capital base to mitigate Lower Tier II capital for Saudi Arabian banking regulatory purposes which is required by SAMA and also under Basel II (Parker, Arab News, 2010).

As the local market favours Sukuk, there is a good business case for originating issuances using a wide range of structures. There is no need for Sukuk issued by banks to be securitized by any underlying tangible assets if they are innovatively structured for the purpose of merely investing in future Islamic banking and finance expansion and growth.

Sukuk are becoming attractive instruments for banks to raise subordinated debt and improve their capital to equal their fast-growing assets structure. “I think the next level for the Sukuk market will be hybrid, or sub-debt, instruments which will help Islamic financial institutions establish efficient capital structures,” said Arshad Ismail, head of Global Sukuk at HSBC Amanah (Ismail, 2007). Big and rated banks can find it easier and even faster to support their capital by Sukuk. Most financial institutions need to diversify their sources of funding and risk mitigation at a reasonable cost, and increase their profile among institutional and individual investors who are seeking low risk and liquid securities like Sukuk.

The inflow of a substantial liquidity into the Saudi economy due to the record oil prices in recent years; and the launching in June 2009 of an automated secondary trading platform by the Saudi Stock Exchange (Tadawul) for Sukuk and bonds trading, in comparison to a previous over-the-counter (OTC) market where Sukuk used to be executed via bank treasuries and settled by Tadawul; augurs well for the demand dynamics of the nascent Saudi Sukuk market. There are currently only five publicly listed Sukuk on the Tadawul stock exchange as shown below in table 5.1 issued by SABIC and SEC; however, Saudi Hollandi Bank, Dar Al-Arkan and the Bin Laden Group have also privately placed Sukuk (Jadwa, 2009).

Table 5.1 Publicly Listed Sukuk on Tadawul Exchange

Sukuk issue	Year issued	Size (SR million)	Yield	Term (years)	Offering
SABIC 1	2006	3,000	3M SIBOR+40bps	5	Public
SEC 1	2007	5,000	3M SIBOR+45bps	5	Public
SABIC 2	2007	8,000	3M SIBOR+38bps	5	Public
SABIC 3	2008	5,000	3M SIBOR+48bps	5	Public
Bin Laden Group	2008	1,000	7% fixed	5	Private
Saudi Hollandi Bank	2008	775	6M SIBOR+200bps	5	Private
Dar Al- Arkan	2009	750	3M SIBOR+400bps	5	Private
SEC 2	2009	5,000	3M SIBOR+160bps	5	Public

Source: (Jadwa Investment, 2009)

As Sukuk is gaining ground in the local debt market, many companies have expressed their desire to tap into the Saudi debt market by issuing Sukuk in 2010-11. Sukuk are suitable alternative financing tools for conventional bonds, and grant investors more options to invest in other than in the equity and the real estate markets.

However, Sukuk are facing serious challenges that need to be addressed in order for them to become established capital market and debt instruments. Some of the challenges are:

1. Lack of breadth: The SABIC and SEC Sukuk listed on Tadawul currently don't genuinely reflect the true situation of the Sukuk market in Saudi Arabia. The entities are 70% and 81% state-owned respectively, and trade on a low spread over SAIBOR. Hence, there is a burgeoning need to vary Sukuk issuance in terms of risk profile and sector representation.
2. According to Jadwa, the lack of liquidity and the lack of experienced human capital in the market are major impediments. As the volume of Sukuk trading in the secondary market is extremely limited, there is a serious liquidity risk. Sukuk structuring and issuing requires a substantial legal, financial and Shariah expertise which is scarce in the market.

Conclusion

Small and medium enterprises (SMEs) in Saudi Arabia who rely on bank loans have been facing difficulties in accessing credit since the 2008-9 global credit crisis. Also, large corporate have been competing with SMEs to obtain bank loans which are making SMEs access to credit even harder. Furthermore, in advanced global economies, SMEs rely on bank loans to get credit, hence, it is absolutely critical to make sure that credit goes to SMEs for them to survive and to create desperately needed jobs to contain the rising unemployment phenomenon in Saudi Arabia. Consequently, large corporate entities must be encouraged to access the capital market to raise needed funds for their expansion to create economic growth.

The Saudi debt market as an essential part of the capital market has a long way to go in its development. It lacks a sufficient legal and regulatory framework to facilitate the issuance of fixed income instruments, including a securitization market for asset backed Sukuk and securities. There is also a need for a Trust and Special Purpose Vehicle (SPV) laws; property rights and insolvency laws. As the Saudi credit market is starting to show some signs of difficulties in the aftermath of the impact of the global financial crisis, the debt market is flexing its muscles to become an attractive option for long-term borrowing. Another major challenge is the enforceability of contracts for the purpose of establishing the credibility of the embryonic Saudi debt market (Ali Ravalia 2008).

In the aftermath of the global economic downturn, some regional Sukuk issuers have faced difficulties in meeting their obligations. Not surprisingly a small number of Sukuk issuers have defaulted in the GCC markets. In the Saudi context, there is also concern over the uncertainty in the rules and regulations with regard to Sukuk holders' rights to the underlying assets and whether they are a preferred creditor or part of the general creditors. Most of the Sukuk issued in the Kingdom are also unsecured and structured under Saudi law.

As the Saudi regulators have recently been intensifying efforts to develop the debt market, it is imperative to stress the importance of the management of the legal process in

Sukuk and bond issuance relating to default or restructuring for investors and other stakeholders. While many potential Sukuk issuers are keen to capitalize on the growing Sukuk market in Saudi Arabia, the CMA needs to build a solid legal infrastructure to preempt any legal risk and uncertainty in the local Sukuk and debt market.

Sukuk remains a vital financial instrument in the development process of the Shariah-compliant debt market as a long-term financing option. Its acceptance as a profitable and competitive alternative to bonds by the international capital markets augurs well for the future development of the market.

Sukuk investments in Saudi Arabia however must be institutionalized mainly by government agencies as a significant driver of Sukuk issuance and the promotion of this innovative and uniquely Islamic debt financing instrument.

Chapter Six

Research Methods

Introduction

In my research, qualitative research methods were implemented as a type of scientific research method to look for unambiguous facts by exploring phenomena. The objective was to understand the research field of study from the perspective of the stakeholders in the market. Qualitative research is an endeavour to precisely explain, translate, and construe the meanings of phenomena happening in their typical common circumstance (Fryer, 1991).

Conventional research design begins with a literature review which then leads to formulating a hypothesis. This hypothesis is then tested by the research. I used grounded theory as the theoretical basis for collecting and analysing the research data. Grounded theory investigates the real world and analyses the data without a preconceived hypothesis (Glaser & Strauss, 1967). Grounded Theory was ‘discovered’ by Glaser & Strauss (1967) in the 1960s. Data collection in grounded theory is usually, but not exclusively by interviews, and case studies, making it a suitable theoretical basis for my research. Grounded theory data analysis involves looking for codes, then concepts and finally categories. Glaser (1992), Recommends identifying key points (rather than individual words) and allowing concepts to emerge. This was the technique I followed.

The theme of my thesis covers an area which is relatively new and under-developed. In some respects this study will set a precedent for a financial market which is still evolving in terms of regulatory and legal framework relating to the Islamic finance industry. The lack of products and issuances of Sukuk in the Saudi market and lack of market-depth means that information and data are similarly limiting, which in turn impacts on the direction of the analysis and the methods of the research.

The qualitative methods and design of my research is based on the following objectives:

- i) to provide an open-end, extensive exploration of an aspect of market.
- ii) to understand the nature of the proposition and to discuss the wider subject matter and to put it in contemporary historical perspective
- iii) to identify, review, analyse and focus attention on some cases.
- iv) And to collect and analyse the relevant data and to draw conclusions as to whether or not the thesis proposition are supported.
- v) to gain a specific person's or group's insights about an experience.

The literature review comprises published articles, comments, reports, official circulars and academic papers written by market players, lawyers, accountants, regulators, academics and financial journalists and commentators. An important source of the above information is The Islamic Finance Project (IFP) Data Bank sponsored by Harvard Law School which has more than 1,128 articles represented in 117 books, magazines and journals (Harvard, 2011). Given the rapid growth of the Islamic finance industry over the last three decades, a cornucopia of literature has also materialised. As such I have in addition consulted, reviewed and analysed a host of other sources as shown in the respective references and notes.

Sukuk is one component of the Islamic finance industry. As such, it is imperative to discuss the basic ethos and rationale of the Islamic system of financial management including its faith-basis, its socio-economic theory, its basic contracts and their position, relevance and impact in current market practice.

Where possible I have striven to illustrate my analysis with tables, charts and graphs, although this was quite challenging given the lack of depth and therefore data and disclosure in the Saudi market in general and for corporate Sukuk issuances in particular.

Given the contemporary nature of Sukuk and Shariah-based finance, it became imperative also to discuss detailed definitions of terminology which is not normally found in conventional finance but which may have structural equivalents. There are for instance over 22 different types of Sukuk (AAOIFI, 2004). However, the research confines itself to the main structures that are prevalent in the Kingdom. These include Sukuk Al-Ijarah; Mudaraba Sukuk; Sukuk Al-Musharaka; Istisna Sukuk, Wakala Sukuk, Murabaha Sukuk and Tawarruq Sukuk

Research Design

This qualitative research is designed to be a traditional descriptive study, posing questions, gathering and analyzing data to and/or addressing concerns regarding the present status quo of the topic of research. My research is concerned with determining the current corporate Sukuk performance, status and market conditions. This is based on a wide range of economic indicators and information such as the Saudi economy, the banking and financial system, the development policy, investment and financing needs and financing instruments such as corporate Sukuk.

Also, I have developed some of my research based on “why” questions. For example, ‘Why do corporate Sukuk have an unlimited buoyant potential in Saudi Arabia?’ In this respect, I have reviewed the existing Saudi Sukuk issuances and the relevant literature of academics, economists and market players.

The following layout assisted me as a guide for my research:

- Introduction – Research Rational and Motivation
 - Research objectives
 - Research questions
 - Research rationale and motivation
 - Research methods
 - Research content and the structure
- Evolution of Sukuk Structures and Mechanism

- Sukuk structure
- Literature review
- Types of Sukuk & their structure and mechanism
- Dynamics of Sukuk pricing
- Dynamics of Sukuk tenor
- Sukuk assets
- Importance of rating Sukuk
- Financial Markets in Saudi Arabia
 - Saudi Arabian money market
 - Saudi Arabian money market Repurchase Agreements
 - Saudi Arabian Government Debt Securities
 - Saudi Arabian Government Development Bonds
 - Treasury Bills
 - Floating Rate Notes
 - Saudi Arabian stock market
 - Saudi Arabian Fund Management issues
 - Legal & Regulatory framework for SAMA, CMA, DIFC & CBB
- Corporate Finance in Saudi Arabia
 - Banks Loans
 - Overdraft Facilities
 - Structured Term Loans
 - Finance against receivable trade finance
 - Informal Finance (Loans or Equity)
 - Partnership finance
 - Equity finance
 - Private equity
 - Public issuance
 - Syndicated finance for mega projects
- New Sukuk Structure
 - Identifying suitable Sukuk structure
 - Sukuk as substitutes for corporate bonds and FRN

- Companies desire corporate Sukuk or bonds over equity finance to avoid suppressing share price by issuing more shares
- The choice between corporate Sukuk or bonds
- Research Methods
 - Research Design
 - Data and Methods
 - Data
 - Data Collection
 - Data Analysis
 - Methods
 - Research Methods
 - Research Difficulties and Limitations
- Case Studies
 - HANCO Sukuk performance evaluation
 - SABIC Sukuk performance evaluation
 - Saudi Hollandi Bank Sukuk performance evaluation
 - SEC Sukuk performance evaluation
 - Dar AlArkan REDC Sukuk performance evaluation
- Semi-Structured Interviews
 - Definition of Semi-structured interviews
 - Interviewees' perspective on Sukuk
 - Importance of the Sukuk pricing
 - Importance of the Sukuk structure & the underlying assets for investors in case of default
 - Importance of risk of the Sukuk underlying assets
 - Importance of the purchase undertaking
 - Importance of Sukuk denominated currency
 - Potential future contribution of Sukuk to corporate finance in Saudi Arabia
 - What is the outlook for Sukuk in Saudi Arabia? What factors are likely to encourage further issuances? Should Sukuk be traded on the Tadawul?
 - How significant is the rating of Sukuk in determining whether to invest?

- Have actual and potential Sukuk defaults in other GCC countries been detrimental to Sukuk issuance in Saudi Arabia?
- "Corporate Perspectives on Sukuk Issuance: Findings from a Focus Group Comprising Saudi Finance Directors
 - The promising potential for Sukuk in the following industries: infrastructures, construction, transport, new economic cities, real estate and mortgage market and telecom
 - Insights of leading Saudi corporate finance directors through the focus group discussion
- Conclusion
 - The long-term outlook for the Sukuk market in Saudi Arabia
 - Challenges facing the Sukuk market in Saudi Arabia
 - Conclusion

Data and Methods

Data

The data was collected from official Saudi government, regulatory, industry organizations, financial information institutions and published materials. The methods of data collection emphasized on the following:

- Case studies are a common method of data collection used in (a) the focus of the study is to answer “how” and “why”, (b) no behaviour can be manipulated in the study, (c) to cover contextual conditions relevant to the phenomena, (d) if boundaries are not clear between phenomena and context (Yin, 2003)
- Semi-structured interview are also known methods for data collections to explore the views, practices, opinions and driving forces of interviewees participants. An open-ended directed conversation that investigates the interviewees’ first-hand knowledge with focus on lived experiences.
- Focus group discussions are recognized methods for data collections where a dynamic group can be utilized to generate qualitative data. This established for a

thorough and detailed group discussions which is outside what normal dialogue meetings.

The time frame of the data in general is 2000 to 2011. I have employed the triangulation methods for data collection – comprising qualitative, quantitative and descriptive information. The triangulation strategy comprised two approaches:

1. **Data Collection**

The methods of data collection in this research is focused on data collected from case studies, interviews and focus group discussions with investors, issuers, Sukuk documentation and offer circulars and specialist sources such as financial data agencies such as Zawya, Bloomberg and Thomson Reuters.

Through triangulation, I have striven to confirm findings and conclusions and examined the positive potential and prospects of corporate Sukuk in Saudi Arabia. It is important to consider the relevance for the analysis of the data for specific periods. The data for Sukuk origination, pricing and yields prior to the global financial crisis in 2008 would be very different to that for the period 2008-2010 when even the Sukuk market was affected by the economic fallout of the global financial crisis. As such, to test my proposition and thesis, a large part of the analysis is based on data collected for the pre-crisis period. This applies to the Sukuk issuance data and, as a comparison, to the data for competing types of financing such as corporate finance and government soft loans (Miles and Huberman, 1999).

Data collection methods included asking questions of relevant stakeholders through semi-structured interviews, focus group discussions and other means to examine the variables that could influence the potential for corporate Sukuk in Saudi Arabia. One-on-one semi-structured interviews with likely investors and bankers helped me to develop a better understanding of the rationale and motives of existing and probable issuers and investors alike. For example, I wanted to know more about how investors make investment

decisions related to corporate Sukuk. These interviews often led to much longer informal discussions on the subject matter (Harrell and Bradley, Rand, 2009). General guiding questions:

- Categories and values
 - How important is this?
 - What does this mean and how significant it is?
- Structures
 - What are the insights the current context that is currently prevailing?
- Processes
 - How does this evolved to become this system

The focus group discussions were also valuable in that they gave honest and frank feedback regarding the strengths and weaknesses of the Sukuk and debt market in Saudi Arabia. This proved valuable in my analysis and conclusions regarding the encouraging future potential for corporate Sukuk issuance in Saudi Arabia.

2. Data Analysis

I conducted qualitative corporate Sukuk research using the grounded theory methods to identify trends in the data and the Sukuk market dynamics. Grounded theory is a powerful method to collect and analyse data and use this to develop meaningful conclusions.

However, there are problems in the interpretation and application of case study, or focus group research, as described by Yin (1994) and Grounded Theory methodology. Yin (1994 p 13) suggests that the case study “benefits from the prior development of theoretical propositions to guide data collection and analysis” whereas Glaser & Strauss (1967) insisted that a grounded theory approach should have no pre-conceived ideas or hypothesis. A criticism of the case study as a research method is that there can be no generalisation of findings. Grounded theory specifically sets out to investigate the real world, usually by using interview data. It discovers the concepts grounded in the data and uses those concepts to build theory. The use of both these methods, therefore,

minimises this criticism. There is, therefore, no real anomaly between the use of case study and the use of grounded theory. Both research methods collect data using interviews.

Therefore, my theory was initiated with analyzing, coding and classifying data as the research design evolved. Explaining the reasons behind the Sukuk current situations and impending development is supported by evidence and collected data. Grounded theory, as an inductive process, helped with building a solid ground by deriving the dissertation from the data collected during the research life span (Qualitative Research, 2011). Data analysis process:

- Data systematizing and arranging
 - Expanding grouping from different related references for more diversity of resources
 - Enhancing grouping from questions about meanings, structures and processes and how they interact.
- Data sorting
 - Based on data importance
 - Based on data contribution
 - Based on data relevance
- Data recovering and assessing
 - Identifying expressive references
 - Widening coverage of related data
 - Characterizing the process
- Drawing conclusions
 - Highlighting positively contributing assumption
 - Extracting associated factors
 - Explaining systematic patterns and consistency

A main aspect of data analysis in my research was the semi-structured interviews, as groups of investors and bankers were asked individually open-ended questions about their experiences and perspectives of Sukuk as long-term financing instruments. One sample question was – ‘What type of Sukuk Structure is preferred?’ The findings of this interview exercise proved useful both in their content and as a basis for analysis.

Given the limited corporate debt and Sukuk market in Saudi Arabia, the historical data and length of trading are limited to the primary market due to the fact that the secondary market remains relatively illiquid with hardly any trading. Trying to evaluate and analyse the demand for Sukuk trading in the secondary market is currently fruitless because of the lack of data due to the nascent Tadawul stock exchange and its Sukuk trading platform which was established as recent as June 2009. As such, I have not attempted to analyse the secondary debt market in this research (Jadwa, 2009).

The data in my quantitative analysis lists the amount, issue date, maturity and coupon rate of each bond or Sukuk. Data was mainly collected from the Sukuk issuances by major institutions in Saudi Arabia. My goal is to assess and support the recent trends and positive expectations for corporate Sukuk in Saudi Arabia and the possibilities for creating a new debt market capable of embracing new debt financing instruments such as Sukuk with the following objectives:

- a) Providing Sukuk instruments sample benchmarks that are equivalent across the debt market.
- b) Weighing up the restrictions holding back corporate Sukuk market growth within Saudi Arabia.
- c) Producing a Sukuk data base to draw on the evolution of debt financing behaviour in Saudi Arabia.
- d) Implementing the current Sukuk performance indicators from recent issues to support the proposition for the promising potential for corporate Sukuk in Saudi Arabia.

Methods

This research method focuses on qualitative methods due to the following (Brown, 2010):

- Limited number of theories to explain the performance of the corporate Sukuk in the Saudi Arabian debt market,
- Limited number of variables,
- Limited perspectives on the subject,
- The research nature requires conducting the research based on relevant literature.
- The need to examine corporate Sukuk cases within the Saudi Arabian market and within the field for more accurate findings,

The research methods will concentrate on corporate Sukuk issued by companies from Saudi Arabia including Sukuk issued by banks and some private companies. The analysis employs qualitative methods to examine the proposition that there is an upbeat potential for a sustainable market for corporate Sukuk. As Sukuk are still in their infancy in Saudi Arabia, the limited Sukuk trading in the secondary market; the lack of transparency in the market and related data, have limited the scope of the research. For instance, any analysis of the secondary market would be impossible because of the absence of such a market and a bond trading culture in the market in general. This makes it more difficult to evaluate the recent trends and expectations of the Sukuk issuances in Saudi Arabia accurately and its capacity to generate liquidity in the capital market.

Nonetheless, my thesis will investigate and examine the evidence for the recent trends and positive expectations for a corporate Sukuk market and whether it could create any investment and real economy benefits. This analysis relies on the data of all Sukuk issued in Saudi Arabia between 2005 and 2010 and will also consider the various demand dynamics for Sukuk issuance in the Kingdom.

To accomplish both sampling methods objectives, I have applied the following:

- i) I have made classified sampling representatives of the total Sukuk issuance to substantiate applications. The overall sampling included manufacturing industries, services industries and other relevant sectors of the Saudi economy.
- ii) I have used convenience sampling, this includes respondents who are easier to select and likely to respond by expressing interest in the sampling from different industries to present statistically-based analyses. Convenience sampling allowed me to identify basic data and trends without undue bias in this research because of the limited numbers of players in this field.
- iii) I have consulted with leading Saudi corporate finance directors through the focus group discussion to develop a market perspective on the prospects for Sukuk issuance.

I have also analysed the general Saudi debt market and the views of corporates on raising financing through debt instruments including issuing commercial paper as part of a diversification of source of financing strategy. The analysis of the Sukuk market is further confined to the success of the limited Sukuk originations in the Riyal market, which have dominated the local market and driven the demand for such investments by local investors (Addas 2008).

Research Methods

I have applied a systematic generation of theory from systematic research to arrive at and develop my proposition on the recent trends and positive expectations for corporate Sukuk in Saudi Arabia.

Methods used in conducting the research:

- Segmenting by categorizing data and information,
- Collecting data and information in a professional way and demonstrating through diagrams in support of the analysis,
- Recognizing the substance and influencing factors,
- Developing approach for the research,
- Outlining the outcome of the strategy.

My corporate Sukuk research is divided into two main groups – academic and applied research. My academic research includes analysis and applied research based on interviews, discussions and the literature of the corporate business sector in the Kingdom.

I have collected primary and secondary data, and analyzed statements and writings of economists, academics, Shariah scholars and market practitioners. I have also researched various approaches to the Sukuk market – whether the Malaysian approach as opposed to the GCC one – especially in the use of debt receivables as an asset class and selling of debt. The Shafie School of Islamic Law, for instance, allows this whereas GCC and Pakistani scholars who follow the Hanbali and Hanafi Schools of Law frown upon this (Thomas, 2007).

To consider the theme of my thesis it is important to understand and discuss the general nature of Islamic finance as a concept – both from a faith ethos and financial market perspective. After all, Sukuk is a small component of Islamic finance and of Fiqh Al-Muamalat.

My applied research in corporate Sukuk in Saudi Arabia is conducted mostly within the industry and involved analysis of the practical problems and challenges relating to corporate Sukuk issuance in Saudi Arabia. These include problems relating to the structure, product innovation, regulatory framework and trust laws, and corporate governance and insolvency issues.

My research uses descriptive methods in the form of literature review and data collection using triangulation methods. For the data collection and presentation, I have used tables, graphs and charts to support my analysis where relevant.

The case studies used are important for the following three reasons (Benbasat et al. (1987) :

- It is necessary to study the phenomenon in its natural setting;

- The researcher can ask "how" and "why" questions, so as to understand the nature and complexity of the process taking place;
- Research is being conducted in an area where few, if any, previous studies have been undertaken.

Case studies are characterized in different schemes and there is no standardized definition. But, according to Stone, 1978; Benbasat, 1984; Yin, 1984; Bonoma, 1985 and Kaplan, 1985) in Benbasat et al. (1987), a case study examines a phenomenon in its natural setting, employing multiple methods of data collection to gather information from one or a few entities (people, groups, or organizations). The boundaries of the phenomenon are not clearly evident at the outset of the research and no experimental control or manipulation is used.

Research Difficulties and Limitations

One of the difficulties facing corporate Sukuk and Islamic finance in general is the interdisciplinary nature of economics, finance, religion, law and sociology (Nazim Ali, 1993). My research deals with the process of transforming Islamic finance theory, which is based on Quranic principles and activities such as avoidance of Riba (widespread sense of unfair increase) and Gharar (speculation), into socially and religiously acceptable economic practice, and its role in promoting tangible productivity, efficiency and development of the real economy (Warde, 2000).

Innovation is the development and application of a new product, process or service and it could include scientific, technical, and market research activities. Due to the limitations of the Saudi Sukuk market, especially the number of issuances, there are limitations in the qualitative indicators of my research. These include the repeated reference to the same Sukuk structures and the limited corporate Sukuk issuance. I have tried to offset this through a detailed analysis of the said Sukuk structures.

Methods Limitations:

- A study of corporate Sukuk: The corporate Sukuk study was limited only to the Sukuk issued in Saudi Arabia.
- Interviews on corporate Sukuk: The sample consisted of expected issuers and investors.
- A study on the timeline corporate Sukuk: focus on practice of Sukuk issuance since 2004.
- Insights of leading Saudi corporate finance directors through the focus group discussions.

This thesis investigated the challenges encountered by new research standards based on a literature review and semi-structured interviews. My research discusses the difficulties related to such standards' primary responsibilities in area of Sukuk structures, legal framework and trust laws. It also discusses the difficulties on how to source and evaluate the data. Given the dearth of quality information and the small number of issuances in the Saudi market, projections of future market activities and potential are fraught with caveats. As such, I have been seeking a rough industry-wide consensus on the future prospects of the Saudi Sukuk market.

Sample Design

I conducted semi-structured interviews and focus group discussions with key figures from major Sukuk issuing entities in Saudi Arabia using standardized survey instruments. It was a consistent sampling method for the purpose of maximizing analogous data throughout the Saudi commercial industry. My ultimate target was to identify how the debt financing industry in Saudi Arabia is evolving and creating a new business atmosphere, and to demonstrate whether the market is ready to embrace new debt financing instruments such as Sukuk.

I have conducted the research sample design with the following objectives:

- e) To present debt financing indicators which are economically competitive across the industry.

- f) To demonstrate that Sukuk can solve the asset-liability mismatch within corporate entities in Saudi Arabia.
- g) To create a data base to trace the progression of debt financing behaviour in Saudi Arabia.
- h) To substantiate indicators which establish Sukuk's capacity to unlock the potential for corporate issuance in Saudi Arabia.

To achieve these objectives using the chosen sampling methods:

- iv) I have generated a sample representative of the total Sukuk issuance to authenticate claims. The overall sample included manufacturing industries, services industries and other relevant sectors of the Saudi economy.
- v) I have used convenience sampling from selected industries sufficient to conduct robust analyses.

My semi-structured interviews and focus group discussions are applicable for corporates with the minimum capability of issuing feasible corporate Sukuk in the market and providing convenience samples to be evaluated. Smaller companies are not potentially able to issue Sukuk, at least in the near term, because of the absence of a clear regulatory and legal framework for Sukuk origination in Saudi Arabia. Hence, the interviews and group discussions are applied and designed to assess the debt financing climate in the Kingdom.

With regard to the sampling methods, I was targeting existing corporate Sukuk issuers and potential issuers to ensure a random sampling of most corporates in Saudi Arabia. This means, all the corporates would have equal opportunity of being selected to be represented in the sampling. The size of the corporate Sukuk issuance must be sufficient in order for sampling to provide genuine value in an environment with sufficient available liquidity. Consequently, the size of the economy and the debt financing industry must be diverse enough for abundant and successful issuances relevant to the Saudi market which are large enough to substantiate such a sampling.

Reliability of Estimates

The figures shown in my research are, in part, estimated from samples and will differ from the figures which would have been obtained from other resources. Two types of possible errors are associated with estimates based on data from semi-structured interviews or group discussions: sampling errors and non-sampling errors.

According to the Experiment-Resources (2009), the accuracy of the results from interviews and group discussions depends not only on the sampling errors and non-sampling errors, but also on:

- i) **Sampling Variability:** The particular sample used for this survey is one of a convenient number of possible samples of the same size that could have been selected using the same sample design. Estimates derived from the different samples would differ from each other.
- ii) **Semi-Structured Interviews and Group Focused Discussions Methods.**

The semi-structured interviews and group focused discussions captured the Sukuk issuers' perception on the biggest obstacles to enterprise growth, the relative importance of various constraints to increase corporate Sukuk issuance, and the effects of Saudi Arabia's investment climate on its competitiveness. Semi-structured interviews and group focused discussions are usually carried out in cooperation with finance directors of business entities that issued Sukuk or have the potential to issue Sukuk.

Interviewees and Discussions

The semi-structured interviews technique is employed to assemble qualitative data, information, facts and opinions by creating an appropriate discussion atmosphere for an official interview over a list of questions and topics in a particular order. This has allowed for interviewees to feel comfortable in expressing their perspectives on the research. The semi-structured interviews and group focused discussions were conducted with finance directors, bankers and other stakeholders of the local Sukuk market in Saudi Arabia

(Johnson Foundation, Qualitative Research, 2008). The purpose was to generate different insights and concepts and expand my understanding for better outcome.

Qualitative interviewing, using the principles of grounded theory, was implemented for open-ended questions, a strategy to fully understand the respondent's observations, examples, narrative, problems and solutions rather than imposing preconceived notions. One-on-one conversations developed a common ground for understanding and consequently helped to find the needed consensus. However, semi-structured interview method has the below strengths and weaknesses (Wengraf, 2001):

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. Constructive understanding and interaction between interviewer and interviewee. 2. Discuss more details with more freedom for interviewee. 3. Clarify and dialogue the respondent's suggestions and comments and answers. 4. Re-evaluate and highlight concluded opinions and challenges. 5. Simple to document interviews (Note/video / audio). 	<ol style="list-style-type: none"> 1. The interviewer's expertise and talent are a major factor in determining the outcome. 2. Interviewer may give out unaware signs that steer interviewee to offer replies presumed by interviewer. 3. Effort and time consuming 4. Low dependability as it is challenging to replicate the identical dialogue scenario. 5. Discussion might unintentionally divert from the core subject and relevancy 6. Personality could heavily influence the interview's outcome. 7. Verification of credibility is hard to implement on interviewee.

The total thirteen interviewees are professionals with enormous experience in the Saudi debt market. Interviews were conducted at their work place or a nearby public place and lasted between 30 to 45 minutes each. All were contacted via individual and specialist networks. Furthermore, interviewees were based in a wide range of Sukuk related industries including banks, oil and gas, and construction. The average career length in

their industries was over 15 years, showing these were in the leading rank in their understanding of the field. The interviewees were asked to write down their own answers for more accurate description and to avoid misinterpretation or misrepresentation. In general I found the respondents to be greatly experienced, committed and inspired, and intellectually thoughtful.

The semi-structured interviews process can be described as interviewer become learner who is keen on listening to experts discuss their experiences in their own terms. The conclusion rests on the contribution of all stakeholders. Also, semi-structured interviews are different from daily conversation in many ways (Rubin and Rubin, 1995):

- Questions are prepared in advance as means for the interview for better analysis and outcome.
- Interviewer steers the interview for focused conversation.
- Interviewing is a philosophy of learning.

Focus Group Discussions

A focus group discussion is a kind of group interviewing in which a small group - 5 to 10 people - is led by a moderator (interviewer) in a freely structured discussion of various themes of concern. The advantages of group discussions are that people interact naturally and give an idea on how a group of people think or feel about a particular topic, give greater insight into why certain opinions are held and helps progress the planning and designing of new programs (Krueger, 1988).

The path of my focus group discussion is designed in advance in order to manoeuvre the discussion for full reporting on the research subject. Even though the members of discussion group had a different professional background, they shared a common interest in Sukuk which facilitated the discussion. There were different approaches of each point of discussion with focus on pertinent issues to keep dialogue on track.

A mini-seminar to conduct focus group discussions was arranged with some corporate finance directors on the subject of the recent trends and expectations for corporate Sukuk in Saudi Arabia. A location was selected in a mini-conference room with seating in a circle in a hotel after a road show meeting for Sukuk, so as to maximize the number of participants and minimize distractions. It was very important to provide a neutral environment to obtain an insight into how these directors think and behave and to explain investors' attitudes.

As a moderator, I was paying attention with care to steer the flow of information and ideas, abstaining from interruption or distracting participants by making comments or suggestions that would prejudice the discussion. However, I was keen on giving a full opportunity for each participant to finish his comments. There was a friendly atmosphere which stimulated discussion so all were able to make a meaningful contribution.

Structure of the Sampling

The core sampling is organized into two parts. The first part sought to conduct semi-structured interviews with investors and bankers for their perspective over broad Sukuk related issues such as:

- a) Sukuk pricing
- b) Sukuk structures and underlying assets for investors in case of default
- c) the risk associated with the underlying assets on which the Sukuk are issued
- d) purchase undertaking,
- e) currency preference
- f) Sukuk contribution to corporate finance in Saudi Arabia
- g) Sukuk best suited for Saudi companies
- h) the outlook for Sukuk in Saudi Arabia
- i) the promotion of Sukuk issuance
- j) Sukuk trading on Tadawul
- k) Sukuk rating
- l) and Sukuk defaults in the GCC countries.

The second part concentrated on assembling a group of eight corporate directors in Saudi Arabia for a focus group discussion to get their insight on Sukuk origination and their views on the positive potential of the local Sukuk market and the constraints in the business environment. A conference call was also held with emerging major likely corporate Sukuk issuers and investors.

Sampling and Weights

The survey targeted possible Sukuk issuers and investors to conduct semi-structured interviews and focus group discussions. In a simple random sample, all members surveyed have the same probability of being selected. This method would increase the estimate's accuracy.

Conclusion

My research program is based on assessing, validating and interrogating the abstract of this dissertation themed “Sukuk issuance in Saudi Arabia: recent trends and positive expectations” and the proposition that there is a growing number of Sukuk originations to meet the increasing demand of corporates as a diversification tool for the sources of funding and as an emerging new Shariah-compliant asset class.

The research also entails systematic analyses of corporate Sukuk issued by Saudi companies between 2005 and 2010; and the conducting of interviews with probable investors to assess future market potential. The author has also consulted with leading Saudi corporate finance directors through a focus group discussion to develop a market perspective on the prospects for Sukuk origination.

Even though there has been a limited corporate Sukuk issuance in the debt market of Saudi Arabia, the demand for subscription (investment) during their offering in the primary market was surprisingly strong, indicating a high level of interest in Shariah-compliant fixed-income instruments.

Chapter Seven

Case Studies

Introduction

The case studies comprise some of the Sukuk originations closed in the Saudi market over the last few years. They analyse the various structures, pricing, rating, purchase undertaking, Shariah acceptability and other Sukuk market dynamics relating to the respective issuances, and are illustrated with relevant flow diagrams, charts and graphs.

Case study research methods are common across different disciplines. Case studies are widely used where qualitative research methods are applied to observe contemporary practices and provide the foundation for the development of theories and extension methods. According to Yin (1984), case study research is an empirical query that explores an existing phenomenon within its real-life context; when the boundaries between phenomenon and context are clearly evident; and in which multiple sources of evidence are used (Yin, 1984).

However, critics of the case study research methods stress that a small sample of case studies can lead to unscientific generalizations and conclusions. However, researchers persist in relying on the case study research methods, with carefully sketched and constructed studies of actual practices, challenges, and problems.

In this chapter, I will be elaborating on how to employ the case study methods and then apply this method to my sample case studies. This project is designed to examine how existing corporate Sukuk, can help in assessing and validating the encouraging potential for corporate Sukuk in Saudi Arabia. The case study will scrutinize the question of whether or not corporate Sukuk have a constructive role, and what their benefits might be to investors and the Saudi economy in general.

I have applied some of the techniques of a pioneer case study used by researchers such as Stake (1995), Simons (2009), and Yin (1984). They have developed such techniques to:

- Determine and define the research questions,
- Select the cases and determine data gathering and analysis techniques,
- Prepare to collect data,
- Collect data in the field,
- Evaluate and analyze the data,

HANCO (Caravan I) Sukuk Performance Evaluation

The HANCO (Caravan I) Vehicle Fleet Sukuk were the first Sukuk origination by a Saudi corporate outside the Kingdom in 2004. HANCO was the originator. Neither the issuer nor the Sukuk was rated by any of the three major international rating agencies. The transaction involved the securitization of a leased moveable and tangible asset (a motor vehicle fleet belonging to a car rental company) for a total of SAR98 million, which was raised from the issue of the Sukuk through an SPV. In addition, SAR4.1 million worth of equity was issued by the SPV. Each HANCO Sukuk certificate has a three-year life maturity and offers investors a 6 percent profit rate throughout its life span. The HANCO Sukuk transaction applies credit enhancement methods with 15.39 percent over collateralization of the assets. Sukuk holders have a low risk investment - protected by 4.2% equity tranche and 8.77% cash reserve maintained in the SPV. The structure also integrates early warning triggers to mitigate operational risk (Volaw, 2004).

HANCO (Caravan I) Sukuk Structure

The Saudi legal framework represents one of the biggest challenges when structuring Sukuk because it puts restrictions on securitization. In the HANCO Sukuk Saudi legislation prevented foreign ownership of locally domiciled assets, meaning that in this securitization a foreign domiciled SPV (Special Purpose Vehicle) could not own the rental company's Saudi assets.

To bypass this limitation, a two-tier SPV/SPC (Special Purpose Company) structure (see figure 7.1) was developed. One SPV was incorporated in Jersey, which issued the Sukuk

certificates. The proceeds of this issue were passed on to a Saudi-domiciled SPC that used the funds to purchase the assets from the originator. That is why in this case there is a dual Saudi Arabian and Jersey structure, where the Sukuk were issued by the Jersey SPV. However, Bahrain's offshore jurisdiction could have been an alternative domicile where there would have been lower transaction costs.

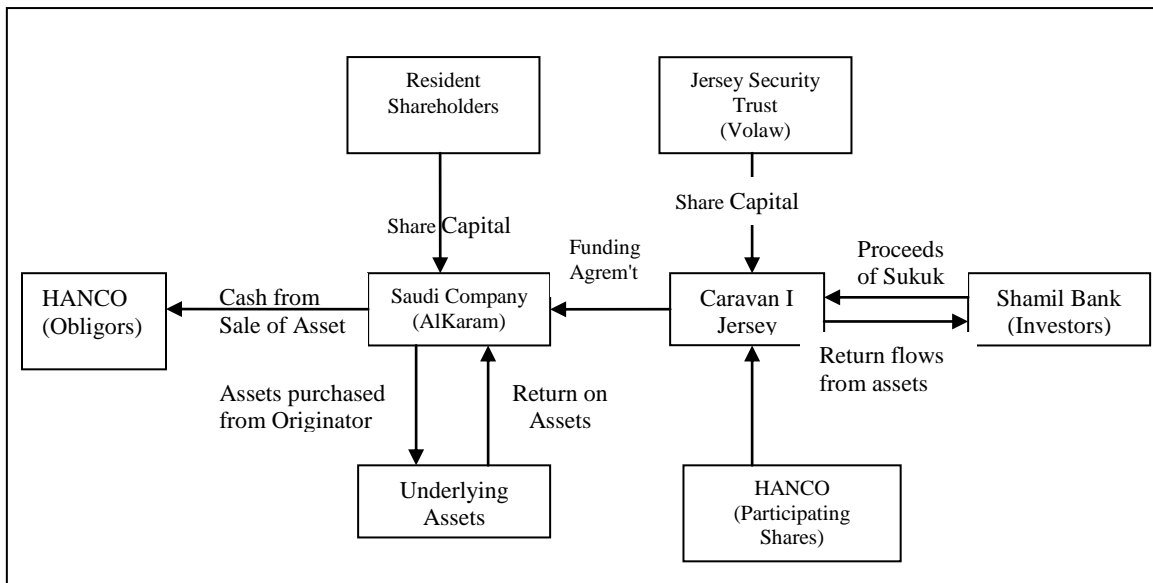
In an interview with CPI Financial, Trevor Norman of Volaw Trust Company, which helped set up the Jersey-Security Trust, explained that the dual Saudi Arabian-Jersey structure was compulsory because the underlying assets (vehicles) were physically located in Saudi Arabia and must be legally owned by a Saudi Arabian person (CPI Financial, 2005).

The lease and title documents had to be transferred to the Saudi SPC for a true sale. However, Mr. Norman confirmed that when they requested the rating agencies to rate the transaction, they were concerned with the ownership of the SPC. They would have preferred to see direct control of the Saudi SPC and its assets by the Jersey SPV for the purpose of seizing the assets on behalf of the investors in case of default. That is why it was arranged for all bank accounts to be in Jersey and administered by a Jersey Security Trustee, which in turn, appointed an Agent in Saudi Arabia to act on behalf of the Jersey SPV. The rating agencies felt this was a still major problem for them to assign a rating to the issue.

According to Mr. Norman, Shamil Bank, the arranger decided that a rating was unnecessary (Norman, CPI, Mar 2005). Furthermore, for the transaction to be Shariah-compliant the structure had to be based on profit and loss sharing mechanism and not on the conventional interest based loan. Making the payment on the Sukuk certificates linked to the underlying assets is a major Shariah prerequisite in order for the transaction to be recognized by Shariah scholars.

Overview of the Saudi HANCO (Caravan I) Sukuk Structure

Figure 7.1: Saudi HANCO (Caravan I) Sukuk Structure



Source: (Volaw, 2004)

The HANCO Caravan I (SPC) Limited securitization is a transaction with a two-tier structure (See figure 7.1), in which the Issuer, a Jersey limited liability company, issued (i) the SAR98 million Sukuk and (ii) the SAR4.1 million Redeemable Participating Shares in the aggregate amount of SAR102,167,281.20; and advanced the proceeds to Al-Karam (SPV) which used the full amount of the advance to pay the purchase price for the Purchased Assets purchased by Al-Karam from HANCO. Al-Karam owned the Vehicles throughout the term of the transaction and tasked HANCO with the operation of the vehicles pursuant to the Servicing Agreement (BSEC, 2004).

The Sukuk had upon issuance an aggregate balance of SR98 million. The Sukuk amortized monthly; paid principal and return on a monthly basis and are expected to be redeemed on or about May 8, 2007. The payment of principal on the Sukuk was arranged to start five months after the Closing Date. The Sukuk were expected to have a weighted average life of 22.6 months (BSEC, 2004).

The pool purchased by Al-Karam comprised 2,344 vehicles, including 2,036 cars, 271 trucks and vans and 37 buses. 797 vehicles (representing 34% of the total number of the vehicles) were used for the leasing business and are subject to long-term agreements; 1378 Vehicles (representing 58.8% of the total number of the vehicles) are used for rental business; and 169 (representing 7.2% of the total number of the Vehicles) are used for the limousine business (BSEC, 2004).

Al-Karam purchased from HANCO 95 existing long-term lease contracts entered into with 69 different corporates. Al-Karam entered into the Servicing Agreement with HANCO pursuant to which HANCO undertook to service the Purchased Assets for the benefit of Al-Karam. The Servicing Agreement was also to provide for a Stand-by Servicer to step in if HANCO were to be unsuccessful in fulfilling its duties. The HANCO Ijara Sukuk structure involved a purchase undertaking of the underlying assets pool from Al-Karam by HANCO (BSEC, 2004).

The issuer was to build up a cash reserve from amounts received in excess of the amounts to be paid in accordance with the Transaction Documents. This reserve was expected to reach SR2.5 million by end of June 2004 and was to be maintained at that level throughout the life of the Sukuk.

The following events would trigger the partial or total sale of the assets:

- The Vehicles yielding less than 66% for a period of three months or more;
- The amount standing to the credit of the Excess Spread Account falling below SAR3.5 million for two consecutive months after reaching the SAR6.1 million threshold.
- The Issuer Cash Account falling below SAR1.5 million on any Calculation Date after reaching SAR2.5 million.
- The amount standing to the credit of the Excess Spread Account failing to reach SAR6.1million by September 1, 2004 (BSEC, 2004).

This unique structure required more credit enhancement procedures to attract investors. As Saudi law bans the ownership of assets by non-Saudi Arabian companies, it was necessary for the Saudi domiciled SPV to own the assets. Yet all cash flow to this vehicle is held in an off-shore bank account (Excess Spread Account), over the security that was taken. Any cash flow surplus is held in the Excess Spread Account, in order to meet any prospective revenues shortfall.

The HANCO Caravan I structure also has a "Retainer on Purchase": meaning the portion of the purchase price of the Purchased Assets to be withheld by Al-Karam until the first Funding Payment Date following the redemption of the Sukuk. The purpose of this is tranching of the assets risk, evidenced by the fact that the originator was paid less than the purchase price of the assets in order to ensure higher protection to Sukuk holders (BSEC 2008). The Sukuk securities over the assets were granted to the trustee (on behalf of the holders of the Sukuk certificates) by rights under the transaction agreements being assigned to the trustee by the issuer.

The HANCO Caravan I Sukuk structure was based on AAOIFI Standard 18 for Investment Sukuk utilizing a two-tier structure to avoid particular Saudi legal restrictions. A critical weakness of this Sukuk is that the structure was extremely complex and difficult to follow. Also, the dual jurisdictions in Saudi Arabia and Jersey have questionable impact on the issuer and investors in case of default. The reason for a dual jurisdiction is that the Saudi Arabian jurisdiction is substantially underdeveloped in terms of legislative and legal infrastructure, and does not permit foreign ownership for locally domiciled assets, compared to the advanced Jersey offshore legislative and legal system. Jersey is considered to be one of the best jurisdictions for tax-exemption purposes. Yet the cost must have been enormous, raising questions behind the real motive for using the costly Jersey jurisdiction instead of the cheaper Bahraini off-shore jurisdiction.

Another weakness of the HANCO Caravan I Sukuk is that the amount was very small; there were too many stakeholders, which meant expenses for the deal was very high. However, as this was the first Saudi Sukuk to be issued, it opened the door for more

Sukuk to be issued by Saudi companies. The issuance also served as a model for future Saudi Sukuk originations especially the structural and legal challenges of issuing Sukuk in the Kingdom.

The creditworthiness of the HANCO Caravan I Sukuk was enhanced by requiring that the issuer build up a cash reserve from amounts received in excess of the amounts to be paid, in accordance with the transaction documents. This kind of credit enhancement should be considered mandatory in most Sukuk cases for risk mitigation purposes.

The HANCO Caravan I is the first deal of its kind in the Gulf where the underlying assets are consumer-linked using a vehicle fleet as security. Backed by vehicles and lease agreements purchased from HANCO, the Sukuk essentially involves HANCO's selling them to the sole underwriter for the entire issue, which is Shamil Bank and then offered a stake to investors. HANCO acts as manager on behalf of the investors, receiving in addition to the payment, a management fee for the operation and maintenance of the fleet, collection of rental income and the disposal of vehicles. The most serious legal issue in this transaction is the genuineness of the segregation of the underlying assets from the originator and the complex Sukuk structure (CPI Financial, 2005).

This is the first Sukuk deal based on the receivables of leased movable assets by a private family-owned company in Saudi Arabia. However, there is no clear regulatory framework as to how to address questions raised in case of default by the issuer, and how the Saudi Arabian courts would rule on the underlying assets, as they were used to securitize the loan for the creditors benefit, by the originator. The underdeveloped Sukuk legal framework could be exploited by some originators, which could cause a setback to the growth of the nascent Saudi Sukuk market. Thus, the underdeveloped title ownership and bankruptcy laws in Saudi Arabia are causing uncertainty for investors and therefore deterring some investors from investing in the Saudi Sukuk market. Hence, we need to consider whether, perhaps, it is in our market's best interest to have enforcement treaties with the advanced western legal jurisdictions and the dominant English law in particular. The enforceability of global commercial awards in Saudi Arabia depends to what extent

the awards satisfy Shari'a principles. This means that the merits of the claim are re-evaluated by the Board of Grievances. Furthermore, the sole arbitration legislation in Saudi Arabia is the Saudi Arbitration Act and it is not established on the UNCITRAL Model Law. Al Ghazzawi law firm and Smith (2010/2011) define the UNCITRAL as: "This law applies where the parties or the subject of the arbitral proceedings are based in more than one country, or where the place of performance or the place most closely linked to the subject matter is in a different country to the place of business of the parties." (Al-Ghazzawi & Smith, 2010/2011)

However, the Saudi Arabian legal system could develop agreements with major global jurisdictions for legal enforcement of only Shari'a-compliant cross-border business contracts such as Sukuk. This will cover the recognition and enforcement of both the court judgments and the arbitral awards without the need to re-examine the merits of the awards. Such an initiative would provide the needed certainty for local and global investors to invest in Sukuk whether domestic or cross-border and would help develop the Saudi legal system compared with western legal jurisdictions.

HANCO Caravan I Sukuk Rating

Rating agencies struggled to establish the creditworthiness of the HANCO Sukuk structure; this was an impossible task for a small company, in addition to the fact that the sole investor, which is Shamil Bank, Bahrain was the only investor in the Sukuk and did not persist in obtaining a rating to establish the degree of risk inherited in the transaction to its purchase of the Sukuk certificates. In addition, there was a need to develop a legal framework and a basis to establish the mechanism for profit and loss sharing and enforceability scenarios under Shariah law.

There is a major dependence on the originator in the HANCO Caravan I Sukuk case, even though the assets have been sold to the Sukuk SPV and the originator is referred to as a "Servicer". A default of a servicer would have harmful consequences on the Sukuk performance (Moody's 2006). Still, the HANCO Caravan I transaction is a cross-border transaction subject to English law and the jurisdiction of the English courts and any

ruling would require ratification by courts where the originator and/or issuers are domiciled and where the underlying assets are located, which is Saudi Arabia in this case. This challenge was one of the main obstacles in obtaining a HANCO rating. It is absolutely important for the Saudi legal system to be compatible with the dominant regulatory systems, such as English law, to facilitate future Sukuk structures (Fitch 2006).

In conventional rating methodology, rating agencies seek performance data by the originator on the Sukuk assets, and in developing markets like the Middle East, wider statistical data on the overall market for those assets is also requested. The Data relating to the default rate of the underlying assets and the corresponding recovery level on those assets is a critical factor following a default (Moody's 2006). However, in the HANCO Sukuk case this is not the case because the issuance is unrated and this was reflected in the high coupon in order to attract investors.

It is pivotal for Sukuk issuers to seek a rating by international rating agencies in order to be able to compete and be attractive comparing to conventional bonds. Rating will also support Sukuk creditworthiness and pricing guidelines to attract a wider global investors' base. A thorough rating course of action would scrutinize different aspects of the Sukuk legal structure, the quality of the underlying asset pool, the ability of the originator to meet the financial obligations, and the structure of the transaction and the repayment mechanism. There are many calls within Saudi Arabia and the region for creating a local rating agency to curb the high cost of rating, especially for SMEs.

Furthermore, Sukuk credit enhancement procedures should be encouraged to substantiate Sukuk appeal for global investors. It is critical for the future of Sukuk to mitigate the current level of intrinsic risk in Sukuk transactions to avoid mass default of Sukuk as new and untested debt instruments. Credit enhancement procedures such as cash reserves, over-collateralization, third party guarantees, bank guarantees and/or insurance coverage could be very important options for solid a Sukuk legal structure. Also, it is vital for the Saudi jurisdiction to recognize Sukuk contracts construed under different laws, like the

dominant English law, in order to attract global investors and their value added essence in developing such nascent instruments.

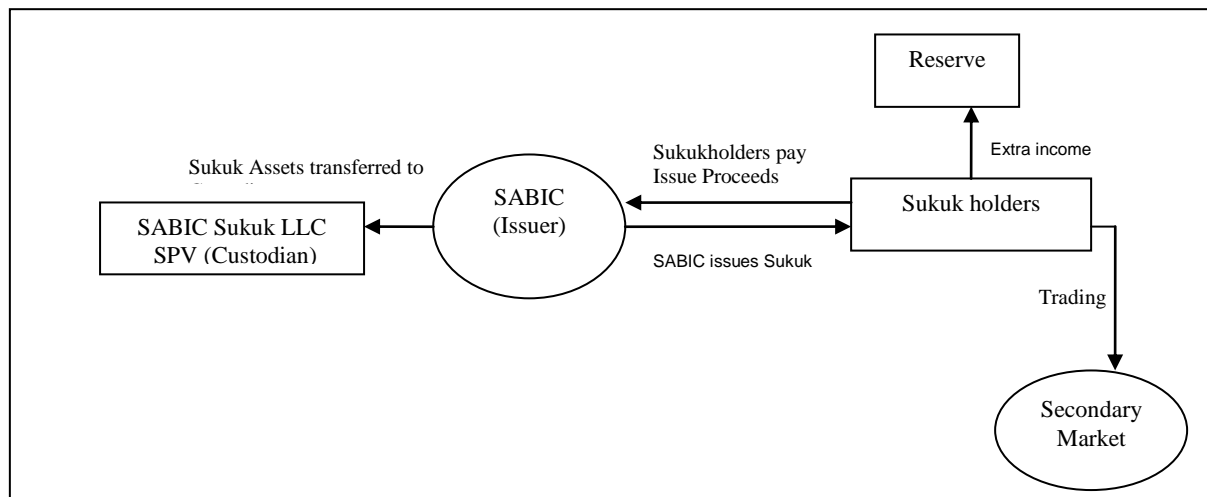
SABIC Sukuk Performance Evaluation

In 2006, 2007, 2008, Saudi Basic Industries Corp. (SABIC) issued three Sukuk (SABIC, A+/Stable/A-1) for billions of Saudi Arabian Riyals (SAR3.75:\$1). The structure of SABIC Sukuk was very inventive where under an asset transfer agreement, SABIC transferred certain rights, and obligations for a specific marketing agreement to SABIC Sukuk LLC, a 100% subsidiary. These represented SABIC Sukuk LLC's underlying assets, which it held as a custodian for the benefit of the Sukuk holders (Rabindranath & Gupta, Watheeqa, 2010).

In this structure, the Sukuk underlying assets should generate the necessary cash flow to cover periodic payments to the Sukuk holders. That is why it is considered that SABIC is only securitizing its cash flow as there are no tangible assets. Furthermore, SABIC is required to purchase the Sukuk from the Sukuk holders when they exercise their right to redeem their Sukuk. Therefore, the originator's ratings were similar to the ratings of the Sukuk.

Overview of the SABIC Sukuk Structure

Figure 7.3: Saudi SABIC Sukuk Structure



Source: (Islamic Finance News, 2006)

SABIC Sukuk Structure

1. Sukuk Assets under Custody during the Sukuk Life
2. SABIC Issues Sukuk (representing ownership in Sukuk assets)
3. Sukuk Holders Pay Issue Proceeds
4. SABIC Manages the Sukuk Assets for the Sukuk Holders
5. Quarterly Distributions to Sukuk Holders are Paid from Income of the Sukuk Assets.(Income from Sukuk Assets Expected to Comfortably Exceed Coupon and Extra Amount)
6. Extra Income Placed in Reserve (upon maturity and after making all Sukuk-related payments, any amount remaining in the reserve goes to SABIC for managing the Sukuk assets.)
7. SABIC Undertakes to buy Sukuk at Years 5, 10 and 15

Features of SABIC Sukuk I, II and III (See Figure 7.3) were based on the Sukuk Al-Istithmaar (investment) structure which in turn is based on AAOIFI Standard 18 Investment Sukuk which issued certificates of ownership against the usufruct of the services of a specified party. Hence, the Sukuk Al-Istithmar structure was developed to identify any possible intangible assets with cash flow generation of the originator to structure the Sukuk issuance. However, the issuer must ensure that this is not interpreted as trading in debt. From a Shari'a perspective, it is considered to be permissible for the rights and obligations of Sukuk contracts to be securitized simultaneously and to become tradable. Under the Sukuk Al-Istithmar structure, it is possible for Ijara contracts, Murabaha Receivables (up to 30%), and Istisna contracts, shares and other Sukuk certificates to be securitized as Sukuk contracts and traded (CHANCE, 2009).

The main challenge of the SABIC Sukuk structure was that SABIC, as a holding company, had only equity assets in many affiliate petrochemical companies. Hence, there has been innovation in securitizing SABIC's assets of limited rights and obligations in

certain petrochemical market contracts for a period of 20 years to be held by the Custodian for the benefit of the Holders (SABIC OC, 2008).

Any surplus income was diverted into a reserve fund as a security cushion to shield Sukuk holders in the unusual event that any periodical net income would fall below a particular amount. This reserve fund was established to protect the Sukukholder from default, up to a given threshold. This means that the risk deriving from the underlying assets is tranching between the Sukukholders and the issuer (BSEC 2008).

The fund is also used to pay 10% of the face value of the Sukuk, every five years throughout the 20-year life of the Sukuk. This ensures that 40% of the face value of the Sukuk is fully paid at years 5, 10 and 15, with a variable rate of return paid to investors on a quarterly basis (SIBOR benchmarked). At the end of the Sukuk tenure, whether it be at 20-years or earlier, if the Sukuk is purchased by SABIC prior to that time, then any remaining balance in the reserve is paid to SABIC with a strong incentive to improve its marketing performance.

In addition, SABIC provides Sukuk holders with a purchase undertaking under which it undertakes (as a direct SABIC credit risk) to irrevocably and individually (no minimum level) purchase the Sukuk for a specific amount on each date (Kamal & Al Sudairy 2006):

- SABIC Sukuk Limited Liability Company (LLC) – SPV
 - Sukuk assets under custody during the Sukuk life
 - Contractually required to hold Sukuk assets as custodian for the benefit of the investors
- Reserve:
 - Built-up in early years
 - Distributed as follows:
 - Shortfalls
 - Extra amount (10% face value) every five years
 - At the end of the Sukuk, as an incentive fee to SABIC

- SABIC obliged to purchase Sukuk (investor option)
 - Investors individually have an irrevocable right to “Put” (a financial contract to acquire the right, but not the obligation to sell the Sukuk at an agreed-upon price at a certain time) at year five. Without issuer right to “Call” (a financial contract to acquire the right, but not the obligation to buy Sukuk at a certain time for a certain price)
- Over-collateralized reserve provided sufficient coverage:
 - Expected to build up more than required amount for fifth year of payment in early years

In spite of this, and as SABIC’s Sukuk structure are asset based, the prospective Sukuk holders should consider carefully the risk underlying the structure, based on the economic performance of SABIC’s affiliates and subsidiaries as a holding company, depending on dividends from its subsidiaries and affiliates, and other fees and charges it generates from certain markets, and administrative and technical services it provides (CPI Financial, 2006).

Thus, SABIC is substantially exposed to any downturn in the profitability of its affiliates and subsidiaries that could affect SABIC’s ability to meet its obligations for the Sukuk holders. In this unique case, an independent feasibility study is required for further risk assessment and any material adverse effects on the SABIC Group’s profitability from the cyclical nature of the petrochemical industry, the variation in the cost of raw materials, and dependence on key suppliers.

Although SABIC has long experience in accessing bank and syndicated loans, its experience in issuing debt instruments like Sukuk is limited and only started in 2006, which is a relatively short time in the nascent Saudi debt market. The Dubai-owned Nakheel near default experience raises questions regarding the regions’ debt issuers and their debt management background and ability. In this case SABIC’s Sukuk underlying assets are based on its marketing agreements.

SABIC Sukuk Rating

In April 2008, Standard & Poor's assigned an 'A+' local currency senior unsecured issue ratings to the SABIC Sukuk-I and SABIC Sukuk-II issuances respectively. The underlying assets involved in the SABIC Sukuk issuance are specific petrochemical marketing agreements into which SABIC has entered. This is a first for the Sukuk sector whereby, under an asset transfer agreement, SABIC has transferred certain intangible rights and obligations for the above marketing agreements, which represent the Sukuk assets of SABIC Sukuk LLC, a wholly-owned subsidiary of SABIC.

Furthermore, Standard & Poor's Ratings Services assigned its A+ local currency senior unsecured debt rating to the SABIC Sukuk-III which matures in 2028. The strength of the SABIC Sukuk structure is in its credit enhancement, as SABIC provides Sukuk holders with a purchase undertaking. The Sukuk are structured to be redeemed on expiration for the purpose of substantially enhancing their credit by equalizing the issue rating with that of the corporate credit rating of the issuer as Sukuk holders are taking the issuer risk of the issuer (Sukuk Summit 2008). Even though SABIC is 70% owned by the Saudi government, SABIC Sukuk do not enjoy any government guarantee as SABIC is a joint stock company which means the government's liability for its debt is limited to its paid-up capital (Tadawul, 2011).

The strength of SABIC Sukuk is in the creation of a reserve fund to be built-up in the early years to be distributed in the case of any shortfalls, with an extra amount (10% face value) every five years and at the end of the Sukuk as an incentive fee for SABIC. In this case, risk has been managed in a balanced manner against any possible future default on distributions or the principal. This kind of Al-Istithmaar structure has proven to be very viable as all SABIC Sukuk issuances have been substantially oversubscribed.

Despite that, the SABIC Sukuk structure was based on diversification of cash flow streams, a strong brand and considerable cash holdings as a major global petrochemicals holding corporation. The SABIC Sukuk structure purchase undertaking has been influential enhancing its Sukuk creditworthiness and acceptability by investors. However,

the Sukuk structure did not completely comply with the required transparency level in Islamic finance, that require the issuer to specify the assets into which the Sukuk proceeds will be invested, even though SABIC Sukuk benefit from a purchase undertaking from SABIC to repurchase the Sukuk underlying assets at maturity or upon default. In this case, there is no unambiguous government guarantee against any claim by creditors. Although SABIC is 70% owned by the Saudi Arabian Public Investment Fund, which is an affiliate of the Ministry of Finance, there is no explicit guarantee by the Saudi government against the SABIC Sukuk default or the risk of not being able to meet its financial obligations (Tadawul, 2011).

Additionally, Shariah regulations are open to different interpretations, giving more unpredictable discretion to courts. This is adding more uncertainty in the legal system for a relatively new investment asset class such as Sukuk. Ratings are more difficult as there is no clear system on which to base them. Yet it is expected that some rating agencies would face some difficulties in rating new Shariah-compliant securities like Sukuk.

Nonetheless, there is a rising demand to develop and set up a systematic rating mechanism by rating agencies in partnership with Shariah scholars and financial institutions. Also, we need to assess our approach towards rating the underlying assets of Sukuk regardless of the issuer's rating.

The scenarios and consequences for default of each Sukuk should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As most Sukuk holders are under the assumption that they have direct rights to the underlying assets, in most Sukuk structure, this is not the case as they are taking the issuer's risk

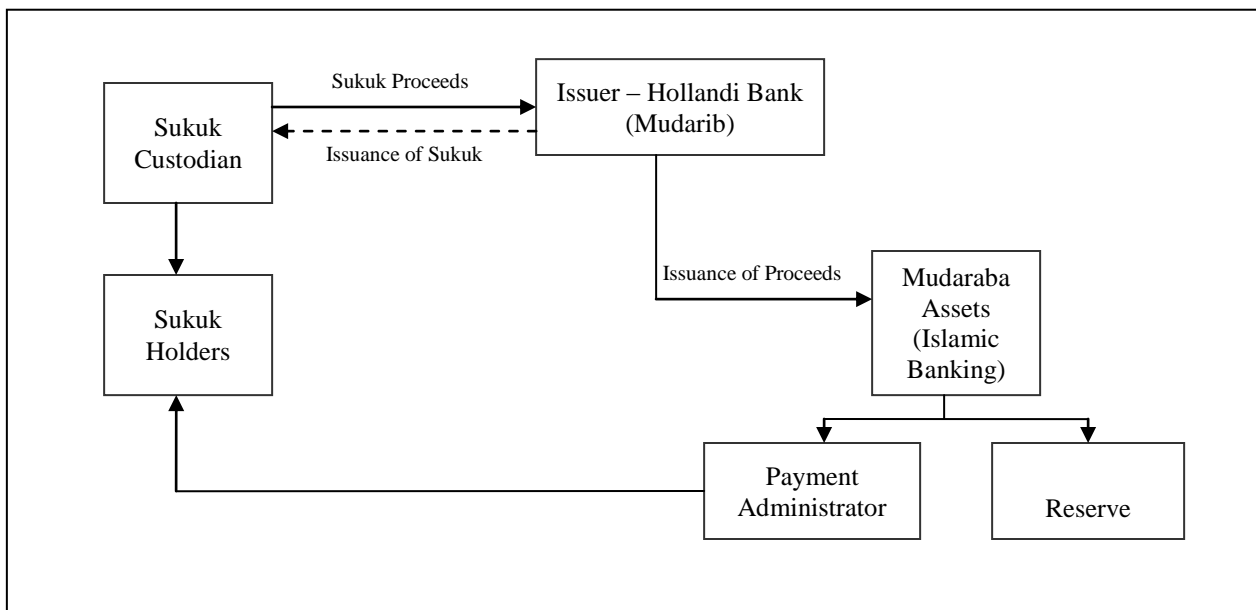
Saudi Hollandi Bank Sukuk Performance Evaluation

Fitch Ratings affirmed the Saudi Hollandi Bank's (SHB) Long-term Issuer Default Rating (IDR) at 'A-' (A minus) with a Stable Outlook. Only a few Saudi banks have issued

Medium Term Note programs including the Saudi Hollandi Bank. However, SHB is the first Saudi bank to issue Sukuk. Most Saudi banks are over-dependant on their funding requirements on short-term funding resources, mainly in the form of stable customer deposits. Prior to the 2008-9 global financial crisis, such deposits had been a stable source of funding, but with the current global financial regulatory evolution, the liquidity of banks has been adversely affected. As such, banks may be required to seek funding from expensive resources, causing an adverse impact on banks' businesses, financial conditions and results of operations. Therefore, this is a critical forward step for the SHB to ensure a stable medium-term source of funding with reasonable costs.

Overview of the Saudi Hollandi Bank Sukuk Structure

Figure 7.4: Saudi Hollandi Bank Sukuk Structure



Source: (Author and Colleague, 2008)

Saudi Hollandi Bank Sukuk Structure

The SHB Sukuk were originated in 2008 and 2009, using a distinctive Sukuk Al-Mudaraba structure (See Figure 7.4) based on AAOIFI Standard 18 Investment Sukuk

where certificates of ownership are issued against the usufruct of described future services. The first Sukuk issued by SHB was a SAR 775 million offering - the first tranche of a SAR 1.5 billion Tier-II Sukuk Programme issued in December 2008 through a private placement.

In December 2009, SHB issued its second Sukuk raising SAR 725 million in a public offering, to be traded on the newly established Tadawul trading platform. SHB Chairman, Mubarak Al-Khafrah commented, "The Kingdom is one of the fastest growing markets in the world for Islamic banking and finance." In addition, Geoff Calvert, SHB's Managing Director explained, "the SAR 775 million Mudaraba Sukuk is a Shari'a-compliant follow-up to the Bank's first Tier-II capital bond for SAR 700 million that was issued in 2004." He added that, "SHB's Sukuk issue is the first by a bank in the Middle East and is expected to set the standard for future Shariah-compliant debt issues in the Kingdom and the region" (Al-Khafrah & Geoff 2009).

The first Sukuk tranche was worth SAR 775 million of a SAR 1.5 billion programme, structured on a Mudaraba basis in order to boost SHB's Tier II capital. The Sukuk are private placements; they have a 10-year maturity and investors have the option to claim them at the end of year five; they are based on a variable rate of return which is SIBOR in accordance with Condition 7(b) (Periodic Distribution) of the Offering Circular, which is paid to investors on a bi-annual basis and the principle amount is to be returned as a bullet payment on maturity.

Below, are the details of the SHB's Mudaraba Sukuk structure:

- Saudi Hollandi Bank as a Mudarib, enters into a Mudaraba agreement with Sukuk holders and issues Sukuk
- Under the Mudaraba arrangement, the Mudarib could shore up the bank's capital to develop its Shariah-compliant services and products with the option to consolidate Mudaraba Sukuk proceeds with its existing Shari'a-compliant business

- The Sukuk holders and the Mudarib agree to share in the return generated by the Mudaraba business, in pre-stipulated percentages (e.g. 60:40)
- Bi-annual distributions to the Sukuk holders are paid from the income of the Sukuk assets
- Extra income is to be placed in reserve to fund any default in any recurring distribution and for any principle loss at maturity or early termination in the event of default
- The cumulative face value of the Mudaraba certificates are payable upon the redemption of the Mudaraba certificates by the issuer upon the event of the expiry date/event of default date, less any loss relating to the Mudaraba assets that are not covered by the funds (if any) outstanding to the credit of the reserve

The proceeds of the SHB Sukuk Al-Mudaraba were used to finance the Islamic banking and finance portfolio of the bank. The structure was suitable for banks as it gives investors the right to call back the Sukuk at the end of its fifth year of maturity, which is favoured by Sukukholders; however the SHB Sukuk was not securitized by any underlying assets. Yet it was innovatively structured to issue Sukuk only for the purpose of future Islamic banking services and products and to finance expansion and growth.

Still, it is stated that the issuer shall be entitled to co-mingle its own assets with the Mudaraba Sukuk proceeds and the income of the assets is benchmarked to SIBOR and the return is not shared with the Sukuk holders. This falls below the required transparency level by not specifying the details as to how and why the proceeds will be invested in the Islamic Business Portfolio; and how they would strengthen the bank's capital base, including Lower Tier II Capital in accordance with Saudi Arabian banking regulatory requirements in line with Basel II.

The following capital instruments qualify as Tier II capital: Hybrid (debt/equity) capital instruments, subordinated term debt/Sukuk subject to the prescribed limit, Reserves arising from revaluation of premises, general provisions and surplus eligible provisions

over expected losses. Still, more clarification is required for the precise usage of the proceeds and the expected returns from each allocation from each banking activity (Parker, Arab News, 2010).

A major strength and credit enhancement for the SHB Sukuk is the accumulation of all extra income which would be placed in reserve to fund any default in any recurring distribution, and for any principle loss at maturity or early termination in the event of default. Despite the fact that the structure provides an incentive for the SHB to capitalize on profit and generate earnings, this might be considered to be a call to invest in risky assets due to the fact that the downside is endured by the Sukuk holders while on the opposite side, the SHB is maintaining the upside. This could be a reason, or incentive, for Islamic banks to take excessive risks (Goud, 2010).

Saudi Hollandi Bank Sukuk Rating

The SHB Sukuk were not rated and they were issued as a subordinated Sukuk issue. The proceeds of the sale of the Mudaraba certificates were used by SHB to grow its Islamic banking and finance activities and its Tier II capital. "This was a challenging transaction involving complex legal and commercial issues, both from Shari'a and bank regulatory capital compliance perspectives, and further demonstrates our extensive Islamic financing and regulatory capital experience," commented Mohammed Al-Sheikh, Partner in White & Case. As the SHB Sukuk was issued as a Tier II capital subordinated debt, investors do not have sole recourse against the assets of the Mudarib (Mohammed Al-Sheikh 2008).

Sukuk are becoming attractive instruments for banks to raise subordinated debt and improve their capital to match their fast-growing assets structure approved by Basel II requirements as Tier II capital. Banks find it even more accommodating to support their capital and funding requirements by subordinated debt, such as Sukuk, rather than to issue equity for capital adequacy requirements purposes. However, there was not sufficient transparency regarding the Islamic banking and financing services and products, what the proceeds will be used for, and what sort of risk level they are planning to take (Evans, Harish, and Ilako, PWC, 2008).

From a risk perspective, it is critical for investors to note that, currently, upon the insolvency of a Sukuk originator, the assets 'involved' would be clawed back into the bankruptcy estate. The Sukuk investors would have no first-lien or prior ranking or security above any other unsecured creditor.

It is this aspect that drives the rating of corporate and bank Sukuk. If the likelihood of a loss on the Sukuk is based not on the assets but on the performance of the originating company – then the rating will be the same as the company's unsecured rating. However, compared to conventional bonds, the immaturity of the market means that most of the special Sukuk mechanisms are untested in a distressed environment (Moody's 2009). In this case, there should be a greater monitoring and control of the originator's performance for detecting early warning signs of any problems.

Kamal Mian (2009), Head of Saudi Hollandi Bank's Islamic banking unit, also said: "The market definitely needs benchmark issues not only for the pricing, but also several of those issues work as an anchor investment for the fixed-income investors," adding that any of Saudi Arabia's 130-plus listed firms can tap the Sukuk market, but the high financial cost linked to ratings from international agencies makes bank funding "always cheaper" (Reuters, 2009).

In this case the collaboration between the regulators, issuers and other stakeholders is becoming a necessity to come up with solutions for developing a benchmark other than the SIBOR and minimizing the cost of Sukuk issuance for local companies, which is a major obstacle for institutions which need to diversify their source of funding.

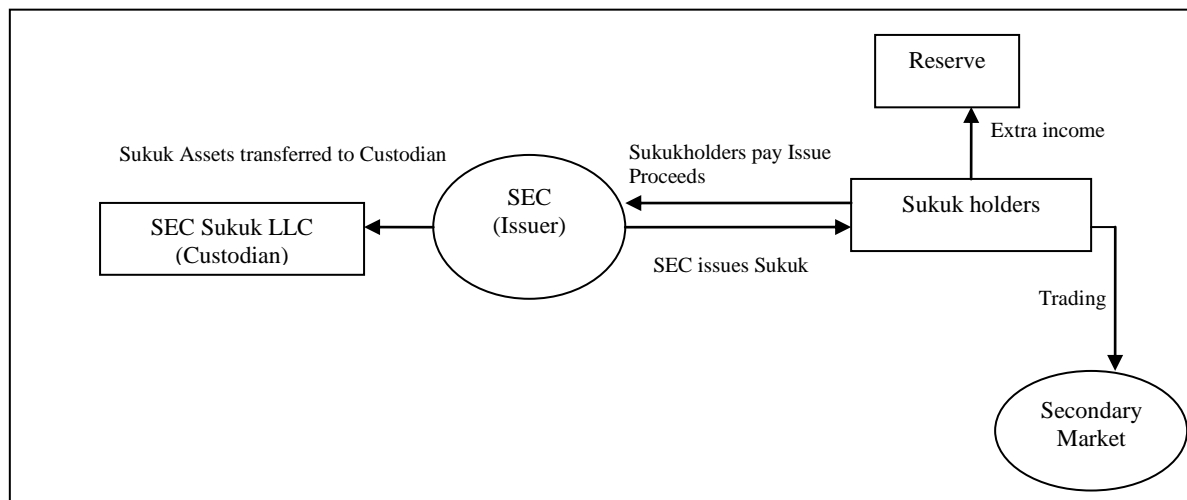
SEC Sukuk Performance Evaluation

The Saudi Electricity Company (SEC) is 74% owned by the government, 7% owned by the state-owned Saudi Arabian Oil Company (Saudi Aramco) and the remaining 19% listed on the domestic Stock Exchange (Tadawul). SEC is the electricity utility in Saudi Arabia and its ratings are aligned with the sovereign rating (Long-term issuer Default and senior unsecured 'AA-', with a stable outlook) of Saudi Arabia. Companies in the Arab

world's largest economy are seeking other ways to finance projects as the global crisis prompts banks to tighten lending. Saudi companies are taking the lead in reviving the Sukuk market after sales plunged in 2008 as falling crude oil prices sapped demand from the Middle East.

Overview of the SEC Sukuk Structure

Figure 7.5: Saudi SEC Sukuk Structure



Source: (HSBC, 2008)

SEC Sukuk Structure

The underlying assets of the SEC Sukuk Al-Istithmar (Investment) consist of SEC (Issuer) transferring to the Custodian the applicable percentage of certain specific rights and entitlements to undertake the Connection Services and levy the Connection Charges for a period of 20 years to be held by the Custodian for the benefit of the Sukukholders. The issuer also undertakes to provide certain services in respect of the Sukuk assets in return for the Administration fee. In this structure case, the Sukuk underlying assets should generate the necessary cash flow to cover periodic payments to the Sukukholders. That is why it is considered that SEC is only securitizing its cash flow, as these are intangible assets. These Sukuk Assets comprise the right to undertake the following services for 20 years:

1. Reading electricity consumption and maintaining meters.

2. Preparing, issuing & distributing electricity bills and the corresponding entitlement to levy charges according to the CMR169.

And the right to levy and receive the charges relating to them

- The instrument is tradable during its life.
- SEC appointed to continue to manage the services.
- For certain Specified Customers only (exclude industrial, agricultural and governmental customers) (HSBC 2007).

SEC Sukuk mechanism is as follows:

- 1 Sukuk Assets under Custody during the Sukuk Life
- 2 SEC Issues Sukuk (representing ownership in Sukuk assets)
- 3 Sukuk Holders Pay Issue Proceeds
- 4 SEC Manages the Sukuk Assets for the Sukuk Holders
- 5 Quarterly Distributions to Sukuk Holders are Paid from Income of the Sukuk Assets.(Income from Sukuk Assets Expected to Comfortably Exceed Coupon and Extra Amount)
- 6 Extra Income Placed in Reserve(upon maturity and after making all Sukuk-related payments, any amount remaining in the reserve goes to SABIC for managing the Sukuk assets.)
- 7 SEC Undertakes to buy Sukuk at Years 5, 10 and 15

Sukuk-based financing remains the most attractive means of raising funds for medium and long-term capital costs for GCC issuers. Features of the SEC Sukuk structure (See Figure 7.5) for I and II originated in 2007 and 2008, respectively. Each Sukuk has tenure of 20 years with a variable rate of return paid to investors on a quarterly basis:

- Sukuk Electricity Company – custodian:
 - Achieves effective segregation of Sukuk assets from SEC’s own assets
 - Contractually required to hold Sukuk Assets as custodian for the benefit of the investors
 - Wholly-owned by SEC, but subject to annual statutory audit
- Reserve:
 - Built-up in early years
 - Distributed as follows:
 - Shortfalls

- Extra amount (10% face value) every five years
 - At the end of the Sukuk, as an incentive fee to SEC
- SEC obliged to purchase Sukuk at investor option:
 - Investors individually have an irrevocably right to “Put” at year five. No Issuer “Call”
- Over-collateralized reserve provided sufficient coverage:
 - Expected to build up more than required amount for fifth year payment in early years
- Meter reading – extremely stable:
 - Default rate negligible; electricity is a fundamental need, low cost and no alternative supplier
 - Investors protected in case of change to tariffs or change in regulatory framework
 - Costs are clearly identified and subject to capping
 - Hence, Sukuk assets comprise extremely stable income source
- SEC commitment:
 - Incentivised to prevent shortfall in payments (disputes, board level support)

The SEC Sukuk I and II issued in 2008 and 2009 respectively are based on the Sukuk Al-Istithmaar (investment) structure (see Figure 7.5) which in turn is based on AAOIFI Standard 18 Investment Sukuk where certificates of ownership are issued against the usufruct of services of a specified Party. The SEC Sukuk Al-Istithmaar structure has similar features to the SABIC Sukuk structure where Sukuk assets are separated from the originator's own assets. The SEC Sukuk creditworthiness and strength was considerably enhanced and underpinned with a reserve fund, obliged to purchase Sukuk at investor option, and over-collateralized reserve to provide sufficient coverage against any possible default. Sukuk Al-Istithmar structures are becoming the favorable option for Saudi Arabian corporations to securitize intangible assets with cash flow generation of the originator to structure Sukuk issuance. Still, the issuers ought to ensure that this is not construed as trading in debt (CHANCE, 2009).

“This issue would be very well received, given the fact that there is ample liquidity with banks and the market is looking for safe investment,” said John Sfakianakis, the chief economist at Saudi British Bank (currently at Banque Saudi Fransi), in an interview from

Riyadh. Mr. Sfakianakis reiterated the positive potential for corporate Sukuk in Saudi Arabia in June 2009 even in the midst of the global credit crunch.

SEC Sukuk Rating

Fitch Ratings assigned an AA- rating based on the same issuer's rating for the SEC Sukuk I and II in 2007 and 2009 respectively issued on an unsecured and unsubordinated basis. The ratings specified general events of default in the unlikely event of a default similar to those seen in conventional bond prospectuses. These include failure to perform any obligations laid down in the agreements, failure to pay any amounts due in the agreements, failure to pay any amounts due, and failure to comply with notices, unlawful actions, and cessations of operations, insolvency, or any arrangements/deferment in relation to any indebtedness.

These events of default may be reinforced by a negative pledge and cross-default clauses, which further link the performance of the originator and the Sukuk. Even though the SEC is 74% owned by the government, and 7% owned by Saudi Aramco, SEC Sukuk do not enjoy any government guarantee as SEC is a joint stock company which means the government's liability for its debt is limited to its paid-up capital (Fitch 2007).

Sukuk are unlike true securitization, as investors do not have any recourse to the underlying assets in the event of default. Default accelerates the purchase undertaking, which, if not satisfied, would cause a claim by the investors against the originator. This would be immediately due and payable, and would be pursued through commercial courts. The assets within the Sukuk would be available for all senior unsecured creditors of the originator and the investors would normally rank as senior unsecured creditors of the originator. They would rank *pari passu* with other senior unsecured creditors, except for any favoured creditors as concluded by local commercial law (Fitch 2007).

The SEC Sukuk benefits from a negative pledge and a cross default clause. This has further enhanced the Sukuk creditworthiness in addition to the scarcity of quasi-sovereign

debt instruments. "The Saudi government has not been issuing any debt recently and investors are anxious to diversify their exposure to establish some balance, especially amid this crisis," one banker said, (Arabian Business, 2009). Nevertheless, it is vital for the embryonic Saudi debt market to develop efficient corporate bankruptcy laws and a regulatory framework in order to develop a more mature debt market.

No securities of a similar character to the Sukuk have, until this time, been the focus of adjudicatory interpretation or enforcement in Saudi Arabia and it is unclear how and to what extent the Sukuk would be enforced by a Saudi Arabian court, or the Committee for the Resolution of Securities Disputes, the Appeal Panel of which has exclusive jurisdiction to resolve disputes in connection with the Sukuk or any other Saudi Arabia Adjudicatory authority (SEC OC, 2009).

Dar AlArkan Real Estate Sukuk Performance Evaluation

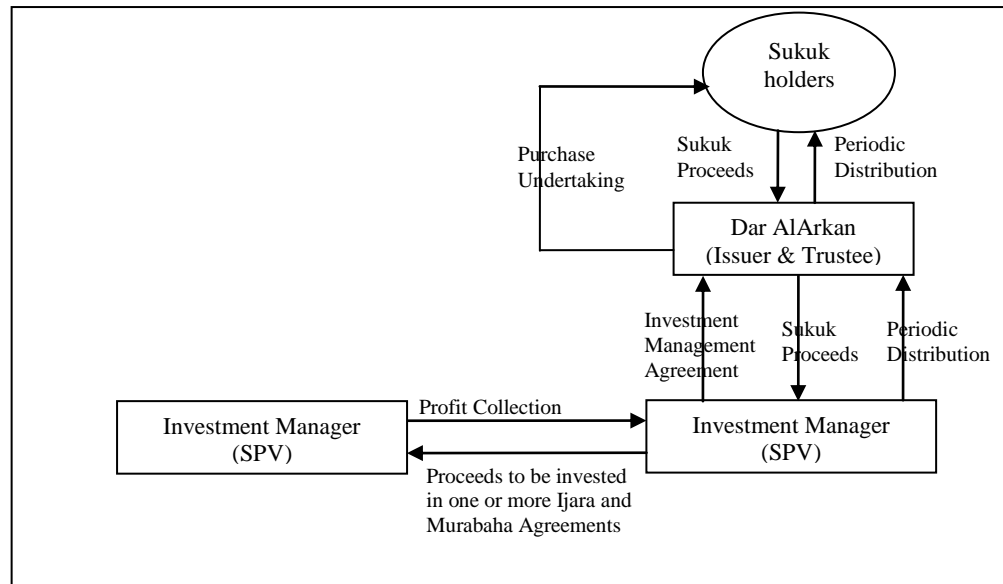
Dar AlArkan (Originator) was not rated by any of the three major rating agencies when it issued its first Sukuk in May 2009. However, the real estate market and impending mortgage law in Saudi Arabia are expected to boost activity in the sector to meet a substantial demand, especially for affordable housing.

The mortgage law is anticipated to precipitate major Sukuk issuance in Saudi Arabia to accommodate a young population's future demand for housing. Furthermore, real estate developers such as Dar Al-Arkan are in a great need of securitizing their assets and mortgages into tradable Sukuk to raise the necessary funds for a growing real estate industry.

Dar AlArkan Real Estate Sukuk Structure

Overview of the Dar AlArkan Structure

Figure 7.6: Dar AlArkan Real Estate Sukuk Structure



Source: (Author & Colleague, 2008)

The Dar Al-Arkan Sukuk structure (See Figure 7.6), comprises a single portfolio of investments with the underlying assets of Ijarah and Murabaha receivables, based on AAOIFI Standard 18 investment Sukuk where certificates of ownership are issued against leased assets and Murabaha certificates:

1. Dar AlArkan will be the Sukuk issuer and the investment agent for the Sukuk holders because only Saudi Joint Stock Company can issue public Sukuk under Saudi law.
2. A special purpose vehicle (SPV), owned directly by Dar AlArkan would act as Investment Manager.
3. The Sukukholders would pay the proceeds to the Sukuk issuer (Dar AlArkan) under an Investment Agency Agreement.

4. The Investment Agent (Dar AlArkan) would make available the proceeds to the Investment Manager (SPV) under an Investment Management Agreement.
5. The Investment Manager (SPV) will submit a detailed Business Plan to the Investment Agent (Dar AlArkan) undertaking to ensure proper Islamic investments, and to avoid investments which will not generate the expected return, otherwise the Investment Manager (SPV) will be liable for negligence and misconduct.
6. The Investment Manager (SPV) will sign an undertaking containing clear legal and business terms to ensure that Sukuk assets are segregated from Dar AlArkan's other assets.
7. The Investment Manager (SPV) will enter into Commodity Murabaha transactions (Tawarruq) with Dar AlArkan's subsidiaries at the inception and at each reset date. The Investment Manager will enter into separate Commodity Murabaha transactions (Tawarruq) with Dar Al-Arkan's subsidiaries for a period equal to the periodic distribution period, wherein the profit and the cost are both repaid by the subsidiary. This is to achieve the objective that the profit rate under each Murabaha is reflective of the current market rate.
8. The Investment Manager (SPV) will purchase assets (land parcels) from the Dar Al-Arkan's subsidiaries and lease these assets to the same Dar AlArkan subsidiary under an Ijarah contract.
9. The Investment Manager (SPV) will form a single or multi-portfolio of investments having the underlying assets of Ijarah and Murabaha. The Investment Manager (SPV) would ensure that at least 51% of the investment is under the Ijarah in order for the Sukuk to be Shariah-compliant for trading.
10. Periodic profit will be distributed to investors, as agreed upon between the parties.
11. The Investment Manager (SPV), under the Investment Management Agreement, will be entitled to a specific amount as fee. The Investment Manager (SPV) will also be entitled to a performance incentive. Likewise, the Investment Agent (Dar Al-Arkan) will also be entitled to a fixed fee and an incentive.
12. The issuer (Dar Al-Arkan) will undertake to purchase the Sukuk portfolio from Sukuk investors at the maturity based on the fair market value.

13. Due to fact that the underlying investment portfolio comprises Murabaha and Ijarah assets, the fair market value of the portfolio cannot be less than the nominal value of the Sukuk on account of the following:

a) The Murabaha receivables due from the Dar Al-Arkan subsidiary should not be purchased for less than the contracted Murabaha price (cost plus profit)

b) i) The leased assets should also be purchased for a value at least equal to the value of the purchase undertaking, provided by the Dar Al-Arkan subsidiary (lessee);

b) ii) The leased assets should also be purchased for a value at least equal to the value of the lease rentals (accrued and future) contracted under the Ijarah agreement, entered into with the Dar Al-Arkan subsidiary (lessee). Hence, it is expected that the fair market value of the Sukuk assets would remain at least equal to the nominal value of the Sukuk and would be represented as such to the investors. Sukuk would supply a sustainable cash flow for the real estate in the absence of the real estate mortgage system.

As Dar AlArkan has two structures - Ijarah and Murabaha, there is a genuine sale of the real estate assets to the SPV under the general Saudi capital market law where creditors can take ownership of the underlying assets in the event of a default. Also, in the absence of a Mortgage law in Saudi Arabia, banks are providing personal loans instead of mortgage loans due to lack of enforcement or foreclosure. Given this, could Dar Al-Arkan subsidiaries apply enforcement foreclosure and repossession of its units and protect its investments in the absence of the mortgage law?

Real estate companies, which are looking to issue Sukuk to finance projects and to provide mortgages, need to make sure that they are not in a real estate bubble, as they would face defaulting mortgages. They also have to ensure the quality of assets being securitised, or they risk investors shunning Sukuk securities and eventually this could lead to a securitisation market liquidity crisis.

Furthermore, real estate Sukuk originators must offer their Sukuk in a satisfactory way backed by the actual developed property which is securitised and supported by market demand. In this respect Sukuk could only be offered to long-term real estate and property development investors. Good results for long-term real estate Sukuk investors could enhance the buying value for the underlying real estate for investors and developers.

Dar Al-Arkan Real Estate Sukuk Rating

Neither Dar Al-Arkan (Originator) nor the Sukuk were rated by any of the three major rating agencies during their first issuance in May 2009. Dar Al-Arkan Sukuk was based on the Ijarah structure, the most common type of structure used in Sukuk issuance, where a special purpose vehicle sells the Sukuk to investors. The SPV buys the assets from Dar Al-Arkan, which then leased them back, providing the SPV with periodic payments.

Had Dar Al-Arkan defaulted, the SPV would have merely become an unsecured creditor. Hence, rigorous risk assessment is necessary. The upshot is that Sukuk are as risky as any emerging-market unsecured bond, Islamic or not. That is why some analysts and regulators alike wonder whether we should assume that Islamic finance products are safer than conventional products, or if the underlying risks should be studied more carefully. "There is some assumption that some of it is cosmetically more comforting, but when so many Islamic instruments are now trying to mimic the effect of conventional products, you need to examine if they carry the same risk profile," Philip Thorpe, chief executive of Qatar Financial Centre Regulatory Authority, told Reuters (Reuters 2010).

Paying rent is a universal procedure anywhere in the world, so local courts might well enforce Ijarah. Moreover, most Sukuk contracts offer a way out of court through arbitration. That again, is no different from any other restructuring of a default: Islamic or non-Islamic, emerging market or developed market. "Most rational creditors will realise that you get more back on a restructuring than on a winding up, which is the logical outcome of successful litigation," said Allen and Overy partner Wedderburn Day (Reuters 2009). However, even though Sukuk need assets to be securitized in a Shariah-compliant method, most Sukuk are asset-based Sukuk like the Nakheel Sukuk, and other

Sukukholders are discovering that they might not enjoy any better creditworthiness privileges than conventional counterparts in the event of default. Therefore, there is a need for greater Sukuk risk evaluation and scenarios of Sukuk dissolution in the event of default.

Conclusion

The credit crunch and global financial crisis have negatively impacted on the performance of all financial institutions around the world over the last two years. Reviewing the Sukuk market performance in 2008 shows the dent that the liquidity crunch has made in issuance. Also, the near default of Dubai developer Nakheel's Sukuk in December 2009 has led to calls for improved bankruptcy laws in the region.

Saudi investors have become more aware of the legal and financial risks in general in the aftermath of the global economic downturn. Most Sukuk structures in the region are offering the same protection as an ordinary unsecured corporate bond in case of default. Still, Standard and Poor's continue to foresee positive prospects for the Sukuk market in the long-term (S&P's IF Outlook 2009). However, according to Mohd Daud Baker, Managing Director of Amanie Islamic Finance Consultancy and Education LLC, Saudi Arabia will lead the Sukuk pipeline this year (2010) as it funds infrastructure projects. He predicted the origination of 10 to 15 Sukuk by corporate (Baker, Reuters 2010).

Legal entitlements, transfer of ownership, purchase and sale undertaking, events of default, insolvency, termination and liquidation and the foreclosure and taxation system are some factors hindering the development of the Sukuk market in the Kingdom. In addition, Sukuk securitization structures should improve their creditworthiness for the Sukukholders and provide them with a set of rights and privileges to mitigate credit risk in case of an originator's default. Fortunately, the creditworthiness of most existing Sukuk structures in Saudi Arabia have been enhanced in the form, inter alia, of cash reserves and over-collateralization, with different categories of rights for investors for the same collateral (BSEC, 2008).

Tranching is an option that is increasingly becoming imperative during Sukuk structuring for improving its status and creditworthiness. The consideration of Tranching techniques for issuance could be essential for Sukuk credit enhancement with the objective of issuing different classes of Sukuk for the same pool of assets carrying different risk and return profiles. Tranching practices are broadly encouraged to minimize the investors' exposure to any risk or losses incurred on the underlying assets. For this reason, Shariah-compliant tranching needs to be developed for the purpose of providing comfort for investors (BSEC, 2008).

Kamal Mian, head of Saudi Hollandi Bank's Islamic banking unit, also said that any of Saudi Arabia's 130-plus listed firms can tap the Sukuk market, but the high financial cost linked to ratings from international agencies makes bank funding "always cheaper." "Rating is expensive ... The (Sukuk) Saudi market needs a local rating agency," Mian told the Reuters Middle East Summit in Riyadh (Reuters, 2009).

In June 2009, the CMA and Tadawul launched an automated platform to promote Sukuk trading in the secondary market. Hitherto they have been traded over-the-counter in the market. The new platform is an order-driven mechanism where all traders publicly post their orders and then best buy and sell orders are automatically matched (Jadwa, 2009).

Nevertheless, as the Sukuk issuance is still limited with only six Sukuk currently being listed, three for SABIC, two for SEC and one for SHB, trading has been very low with only 50 transactions in the first two months of trading on the platform (Jadwa, 2009).

Recent Sukuk issuances have been using double structures by mixing different underlying portfolios. In essence, Sukuk characteristics are evolving significantly, with more innovative structures coming to the market to meet the various needs of issuers.

While terms such as Mudarabah, Musharaka and Ijarah are widely applied, the actual legal structure behind the 'contract name' and Sukuk risk characteristics can vary significantly, even within a single 'type'. Thus, until there is some broad consensus on standardisation on terminology or form, investors will need to look at each structure

individually to understand the cash flow, and risk and return profile, irrespective of the name/type of Sukuk structure used (Moody's 2009).

Chapter Eight

Semi-structured Interviews with 13 People

Introduction

The aim of semi-structured interviews is to obtain perspectives of opinion, reflections and comments from those who have special knowledge, expertise and information and who hail from specialised allied professions involved with the Islamic finance industry. Semi-structured interviewing is more adaptable than the other research methods, such as the structured interview or survey. Through this technique I explored, sought and focused on the feedback of interviewees on the structural issues of the Sukuk market and issuance. This allows for a more accurate understanding of the respondents' points of view. The flexibility of the semi-structured interview permits for a conversational dialogue with change of the order of the questions and/or the way they were worded (Hockey, Robinson and Meah, 2003).

I also conducted semi-structured interviews with investors and bankers, and with representatives of different major expected Sukuk stakeholders in Saudi Arabia, using nine different semi-structured questions covering various aspects of Sukuk origination including pricing, structure, tradability, and the outlook for Sukuk in Saudi Arabia in the aftermath of a small number of Sukuk defaults in the region. I also conducted a number of surveys amongst market players to widen the perspectives of the feedback on the above issues to capture the depth of their experience.

Definition of Semi-Structured Interviews

The semi-structured interview is a method implemented to accumulate qualitative data by creating circumstances (the interview) that provides respondents the time and capacity to talk about their outlooks on an identified issue. Semi-structured interviews are conducted in an open and informal manner which allows for frank discussion and exchange of information (Denscombe, 2007).

I have developed a sustainable professional relationship with the participants to enhance the quality of the questions and consequently the analysis, and to allow for follow up questions and clarifications where needed. Participants were able to explain their views in detail and to discuss issues which may be sensitive on a confidential basis. The interviews were started with pre-set questions which paved the way for a detailed discourse on the subject matter.

Interviewees Perspective on Sukuk

The consensus amongst the thirteen interviewees I interviewed was that the Saudi Arabian Sukuk market will continue to grow gradually and the demand drivers will be the massive financing requirement for the Kingdom's infrastructure projects, which will be led by the government-owned entities. The launching of the Tadawul Sukuk platform has substantially enhanced the prospects of Sukuk becoming a pivotal investment asset class, particularly for local investors.

The size of the Saudi Arabian market puts it in pole position to lead the Sukuk market in the Gulf Cooperation Council (GCC) countries. A significant proportion of Saudi companies are required by regulators to place a substantial percentage of their investments in local currency assets, and Sukuk is emerging as the most popular Shariah-compliant asset class.

During the semi-structure interviews, it was clear there has been increasing optimism in the Saudi market as regulators are currently finalizing the development of its first mortgage and finance law, which is expected to be introduced in 2011. All the interviewees are anticipating a better uptake in the Saudi Sukuk market as companies and issuers seek to diversify their sources of financing.

They were encouraged also by the greater awareness amongst local businesses of debt market instruments such as Sukuk. Indeed seven bankers confirmed that their institutions will invest in Sukuk for investment diversification reasons, especially away from equities. Many fund managers and institutional investors are indeed seeking investments

in Sukuk and cannot wait for the development of an active primary and secondary market.

Importance of Sukuk Pricing?

The Semi-structured interviews highlighted the importance of pricing and book-building of Sukuk. Risk and price are the major drivers for any investment product, including the nascent Sukuk asset class. However, an illiquid Sukuk market, because of the lack of an active secondary market, could distort the pricing of future Sukuk issues, thus putting a dampener on future issuance.

Ten out of the thirteen interviewees expressed concern over the effect of the global credit market crisis on Sukuk pricing, which they maintained could further distort pricing and could threaten the ability of issuers to raise funding via Sukuk. “The problems would be in terms of the ability to properly price the Sukuk,” says Badlisyah Abdul Ghani, (2009) chief executive of CIMB Islamic Bank in Malaysia, which is the world’s top Sukuk arranger (Arabian Business, 2009).

Both issuers and investors take pricing very seriously with the increasing interest in issuing local Saudi currency denominated Sukuk. Also, both issuers and investors were satisfied over the reliance on quasi-sovereign Sukuk such as the SABIC and SEC issuances as a benchmark for their investment decisions. However a majority of the interviewees were keen to see sovereign issuances which they stressed would better serve as a pricing benchmark and yield curve for Sukuk, instead of the conventional SIBOR or LIBOR benchmark.

One prominent banker had strong reservations about the lack of liquidity in the secondary market, which he stressed further distorted Sukuk pricing. In addition, the volume of Sukuk trading is very low, even after Tadawul launched the electronic Sukuk trading platform. All the Sukuk issuances to date in Saudi Arabia have been oversubscribed many times, in addition to the fact that most Sukuk investors are keeping their Sukuk on hold-to-maturity basis.

The rarity of Sukuk issuance in Saudi Arabia reflects distortions of the pricing mechanism and therefore, Sukuk pricing does not reflect their actual market value. However, all of the interviewees are hopeful that with the need for more Sukuk issuance, due to the massive infrastructure projects in Saudi Arabia, the secondary market will steadily develop and become more liquid as trading volumes start to increase gradually.

Eleven out of thirteen respondents reiterated the importance of the book building process, where the price is determined by the dynamics of demand and the book size. Gulf International Bank (GIB) withdrew their planned Sukuk issuance in November 2009 due to the unfavourable pricing during the book-building process which coincided with the downturn in the regional market. When Nakheel in Dubai announced the restructuring of its debt and the repayments due on its Sukuk, it negatively impacted on the pricing of the proposed GIB Sukuk pushing it too high which prompted its postponement (Cohn, 2009).

This shows a clear correlation between Sukuk pricing and market conditions, which can be very volatile in the GCC region. A Sukuk default in the Saudi Arabian market, in the context of poor legal and court process, could adversely affect future Sukuk issuance. However these risks would be incorporated and reflected in the pricing of Saudi Sukuk originations.

A few interviewees raised the issue of the difference in pricing between the SABIC and SEC Sukuk on one hand, and Dar Al-Arkan and Saudi Hollandi Bank (SHB) Sukuk on the other hand. Dar AlArkan and SHB paid a higher premium over SIBOR than the government-owned entities which provided greater confidence to investors. Some of the interviewees expect more Saudi public and private companies to issue Sukuk.

The interviewees agreed that Sukuk pricing should be mainly affected by market forces, in order to make Sukuk attractive and competitive against conventional bonds. One interviewee said that pricing was the over-riding factor for a corporate to issue or not to issue a Sukuk. Others reiterated that they preferred to see the market adopt a different

benchmark, other than the Saudi interest rate driven benchmark SIBOR, such as the Saudi non-oil GDP (Gross Domestic Product).

In a published simulation, Dr. Rodney Wilson, Professor at Durham University, UK, has shown that in comparing Saudi non-oil GDP versus SIBOR, non-oil GDP was more stable as measured by the standard deviation. Prof Wilson thinks that investors are sharing risk in a more meaningful way if non-oil GDP is used. As non-oil GDP rises corporates would be in a position to pay a higher returns, and when it is lower there are reduced debt servicing costs.

Importance of the Sukuk Structure and the Underlying Assets for Investors in Case of Default

The interviewees agreed that the Sukuk structure and the underlying assets are important for investors, especially in the case of potential default. Eight out of thirteen interviewees agreed that Sukuk should be classified as asset backed securities with tradable rights and obligations to the underlying assets. Nonetheless, five out of thirteen interviewees prefer to invest in an asset based Sukuk to take the originator's risk, due to the lack of developed legal infrastructure and enforceability in Saudi Arabia in the case of default.

Six out of thirteen of the interviewees expressed their concern whether Sukuk are more secure than conventional bonds, as they are asset backed with tangible assets. With the near default of Nakheel and the default of Sukuk in Kuwait, the same interviewees were wondering, in case of default, if they would have direct recourse and a priority claim over the underlying assets against other creditors.

Most Sukuk structures are developed to offer recourse by initiating the selling back to the originator at maturity or in the event of default. This is why six out of thirteen interviewees thought that the importance of the underlying assets in the region has little effect, due to the fact that the underlying assets are used to generate income and not for credit quality. However, one interviewee was of the view that the underlying structure of

the Sukuk discourages over-exposure of the financing facility beyond the value of the assets, given that the issuer cannot leverage in excess of the underlying asset value.

Additionally, some interviewees commented on the low level of transparency in the Sukuk documentation, with little disclosure on the underlying assets. The disclosure documentation is mainly focused on the originator's balance sheet, business and risk profile as regional investors are in favour of having risk exposure to the obligor's credit. This fact is encouraging Sukuk issuers to structure their Sukuk with an asset based structure. At the time of the global financial crisis, many local Sukuk investors became more sophisticated regarding Sukuk structures, and started to insist on more credit enhancements in structures

The enforceability over the underlying assets in case of default in Saudi Arabia is an important and new concept. The interviewees had doubts over the occurrence of the collateralized true sale of Sukuk to the Sukukholders. The regional Sukuk defaults have proven that there is a flaw in the Sukuk structure implementation, due to the lack of a transparent legal framework. Hence, the legal system must be developed to address the fate of the underlying assets if there is an insolvency of an originator in case of default. This potential obstacle can only be addressed if the Sukuk securitization contract was truly transferring the underlying assets to the SPV.

According to Khalid Howldar from Moody's, "Many of the current Sukuk types adhere to AAOIFI in form, but not in substance" (Moody's, 2009). Sukuk bankruptcy laws should be clear and straightforward to deal with unexpected Sukuk default scenarios to avoid any legal shortcomings. All Sukuk default legal procedures pertaining to legal transfer should be illustrated clearly. A comprehensive Sukuk regulatory framework is fundamental in confronting all the legal challenges that could face the future development of the Sukuk market.

Importance of Risk of the Sukuk Underlying Assets?

On the question of how important the risk of the underlying Sukuk assets is, seven out of thirteen respondents commented that it is very important only if there were a true legal sale of the underlying Sukuk assets which is not so in all cases; however, four out of the thirteen respondents thought that it is relatively important; and two out of the thirteen interviewees thought that it is not important as most Sukuk issuances are unsecured. The rising risk of the underlying assets for some regional Sukuk caused fear among investors due to the 2008-9 global financial crisis.

Eleven interviewees were wondering what the true nature of the Sukuk is, as they are still vague in terms of being secured or unsecured from an asset outlook. They also share the thought that underlying structures are legally complicated, making them difficult to understand.

Two interviewees argued that they choose to take the risk of the originator over the risk of the underlying assets, as this creates less complication in the Sukuk structure. Eleven participants felt that they would only take the risk of the underlying assets if there were a true legal sale of the underlying assets and all other risks are covered including the jurisdiction of enforceability. It is also critical to include the risk of pricing the assets, the quality, and life of those assets.

All the interviewees were interested in more risk assessment as it is becoming a very important aspect when analyzing the risk in the underlying assets, due to the fact that the limited transparency in the documentation is causing a critical lack of understanding of some of the Sukuk instruments. As a result, more investors are increasingly demanding greater transparency and extensive due diligence when it comes to securitization of assets.

The prudent financial engineering of securitization could bring real economic benefits by giving originators an option to make off-balance sheet borrowing via Sukuk issuance. One interviewee expects that if future Sukuk investors do not possess realizable security

over the assets, then the credit risk assessment will be directed towards the entity with the obligation to redeem the Sukuk. He is advocating that this issue is based on the risk profile of the underlying assets, and Sukuk investors should have ownership and realizable security of the assets.

Two interviewees were apprehensive about the different legal structures as they are linked to the evolution of the different Shariah interpretations from different scholars. The need for a standardized legal and Shariah framework to is vital to boost confidence in the Sukuk market. The recognition of the underlying assets construed in the Saudi jurisdiction for the purpose of enforcement is a source of risk because of the lack of a legal and Shari'a infrastructure in Saudi Arabia, and a poor transparency. Also Sukuk defaults have yet to be tried and tested in the Saudi courts.

Two interviewees proposed that Shariah principles and interpretations should be incorporated into Sukuk agreements governed by any commercial and legal jurisdiction. This legal structure for Sukuk agreements could add significant value for the credibility of Sukuk contracts. These interviewees agreed that a uniform harmonized Shariah framework for Sukuk would be difficult to reach among Shariah scholars as they come from different Schools of Islamic Law.

At the same time, three interviewees thought that the diversity of opinions is a valuable concept as it enriches the ideas for more evolution.

The subject of more Sukuk based on equity in underlying assets was brought up during the discussion. Three interviewees agreed that the concept of partnership of the underlying assets, with a profit and loss sharing mechanism, is a constructive scheme that needs to be further developed. As banks and most other institutional investors implement risk averse funding policies, the thought of equity-based Sukuk is still considered to be remote. Plus, some potential corporate issuers seem to be disinclined to share their upside profit with their equity investors. Hence, the best option in the meantime is to nurture more research to develop an economically viable equity based Sukuk.

Importance of the Purchase Undertaking

On the importance of the purchase undertaking, eight out of thirteen respondents commented that it is very important to have a purchase undertaking to establish corporate credit, and provide collateral to investors to shield them from any potential losses. However, two respondents thought that the guarantee of purchase undertaking during the process of Sukuk structuring is moderately important as long as it is Shariah-compliant. Three respondents believed that it is not important, as they are taking the risk of the originator.

The majority of interviewees insisted that the purchase undertaking is a deciding factor in Sukuk structuring to provide comfort for investors and to give a claim that can be effected in case of default. This market driven decision which most investors require, can be triggered if the Sukuk obligor is encountering difficulties with respect to financial obligations. The purchase undertaking clause is critically important in Saudi Arabia as it is being applied in the SABIC and SEC Sukuk for investors, as it could make or break any Sukuk transaction.

However, in discussion some interviewees stressed that the lack of enforceability of the purchase undertaking would endanger the trustworthiness of such a vital clause in any agreement, if it is not applied in Saudi Arabia amid an unclear legal environment. Therefore, it is absolutely necessary to establish a legal framework governing the purchase undertaking arrangement. Investors should be aware of the regulatory framework and the mechanism of implementation and enforceability in order to rule out any misinterpretations. This irrevocable and independent agreement should be addressed by authorities, issuers and investors in defined and specified cases. In particular the due diligence process, or rating agencies, need to ensure that the purchase undertaking is enforceable under the law of the country in which the issuer and originator is domiciled.

Discussions included the importance of verifying the ranking or priority in the capital structure when structuring a purchase undertaking of Sukuk for better understanding of

the underlying risk for the underlying assets. Also, the due diligence process and rating agencies need to check the ranking of the purchase agreement against the senior unsecured debt of the originator. The risk of the Sukuk underlying assets could be unlimited and hidden in markets that are not fully tested. The unrealized risk within the underlying assets could be grave if it is not carefully calculated and fully explored among Shariah scholars and law makers.

Ten participants recommended that rating agencies should be involved in evaluating the legality of the purchase undertaking provision, for better risk assessment. Rating agencies could contribute substantial value with their vast professional background in purchase undertaking, due to their expertise in the conventional debt market. The effectiveness of the purchase undertaking has a huge impact in promoting Sukuk, as it enhances the creditworthiness of the issuance in the eyes of the rating agencies. That is why any structural flaw in the purchase undertaking for any of the major Sukuk could have damaging consequences for the future of Sukuk issuance.

Nine out of thirteen interviewees were concerned about the grey area regarding the stand of Shariah scholars in terms of initiating and exercising the purchase undertaking clauses of different Sukuk structures if the originator defaults. There was major anxiety when the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), commented in November 2007 that certain purchase undertakings of Sukuk were not Shariah compliant. The reason for that is that the principal being purchased back was at the same nominal value without any risk exposure to investors (Arabian Business, 2008).

All participants expressed their understanding of why most institutional investors do not wish to take the risk of the fluctuating market value of the underlying assets at maturity, due to the fact that they are in no position to take market risk.

Importance of Sukuk Denominated Currency

Most of the interviewees favoured Saudi riyal denominated Sukuk, as most Saudi investors prefer riyal for asset classification purposes. However, one or two respondents

stressed that currency diversification is equally important because currencies such as the US dollar or Euro are more liquid and could attract more global investors.

According to Dr. Nasser Saidi, Chief Economist at the Dubai International Financial Center (DIFC), there have been significant changes in currency of choice for the Sukuk market in the Middle East on one hand, the share of US dollar-denominated Sukuk dropped from 85% in 2002 to 10% of issuance in 2008. Conversely, Sukuk data for the year shows a turn around with US dollar denominated Sukuk rising to 20% of total issues, indicating the return of the green back as one of the main currencies (Dr. Nasser Saidi, 2009).

The reason for this is the uncertainty over the adoption of a single currency for the GCC and the formation of a GCC Monetary Union. The fact that all the GCC currencies, save the Kuwaiti Dinar, are pegged to the US dollar is also a factor in this respect. All the Sukuk issuances by the Saudi issuers during 2009-10 are Saudi Riyal denominated except for the Dar AlArkan Sukuk, which was a dollar denominated Sukuk, launched in the global market and listed on the London Stock Exchange.

On the other hand, the large majority of the interviewees who would invest in Sukuk preferred Saudi Riyal denominated Sukuk, as long as they are pegged to the US dollar with a stable outlook. They also stressed that the Saudi government monetary policy with regards to the Saudi riyal which has been pegged to the dollar for the last few decades, had given the currency a degree of stability and this in turn has inspired market confidence of the monetary system. Although the dollar continues to be the currency of choice for regional Sukuk issuers, Saudi issuers have favoured issuing Saudi riyal denominated Sukuk to tap into the liquid and sizable local debt market. All thirteen interviewees thought that local demand for Sukuk is a market driven decision, demanded mostly by Saudi government entities and financial institutions that are major investors in the market, and obliged by regulators to invest in local currency asset class.

The interviewees were bullish about a strong growth in the nascent Islamic insurance sector (Takaful) which in return is expected to invest its returns in Shariah-compliant fixed income instrument such as Sukuk. The Saudi Arabian Monetary Agency (SAMA), the banking and insurance regulator is requiring financial institutions and insurance companies to invest part of their capital and portfolio in a liquid Saudi riyal denominated investment assets class. There have been discussions on how to increase the volume of Sukuk issuance to facilitate the burgeoning Takaful market. According to Antoine Issa, chief executive of Allianz Saudi Fransi insurance company, "The sector's growth is certainly going to help the local bond industry." Major Banks are competing with the nascent Saudi Takaful companies on buying most of the rated Saudi Sukuk offerings, leaving Takaful companies with little or no Sukuk for investment (Arabian Business.com, 2010).

The interviewees noticed that the outlook for the Saudi Arabian riyal, as the choice of currency for local issuers, has been gaining ground even for major issuers with plans for global expansion. The Saudi riyal has proven to be a reliable currency for local and global investors alike. Most local institutional investors would like to see more Saudi riyal denominated Sukuk. Saudi Arabia could become the most important local currency Sukuk issuer in the region as it possesses the biggest and most liquid regional market size and financing obligations.

However, one interviewee felt that the features of the preferred currency should be liquid but, the form whether it is pegged, floating or otherwise, is also important especially at times of high currency speculation. There is an incipient risk to currency exposure which is evaluated according to the market conditions and liquidity. Another interviewee highlighted that fact that currency preference is like any other FX-denominated investment, choice of the issue's currency is important as a means of maintaining the FX exposure arising from any mismatches between the corporates' liabilities and revenue streams.

Potential Future Contribution of Sukuk to Corporate Finance in Saudi Arabia

Interviews concurred on the importance of the use of Sukuk for corporate finance in Saudi Arabia. The recent financial crisis, they stressed, has demonstrated a shift away from bank lending and to more long-term financing instruments such as Sukuk for diversification purposes. Nonetheless, in recent years Sukuk have expanded considerably as more major corporate entities are interested in engaging in longer duration financing instruments to meet their long-term expansion.

The consensus was that Sukuk can, to a large extent, provide more financing options for diversification purposes. Moreover, increasing Sukuk issuance will provide additional investment options for investors as an important factor for their portfolios' sustainable growth. Three interviewees observed the domination of the Saudi Sukuk issuance market by government-linked entities, which they thought were showing good leadership in Sukuk origination which in turn could provide a concrete base for smaller corporate entities to go to the market to raise financing through Sukuk issuances.

Five interviewees thought that Sukuk issuance should be increased considerably to offer more to meet the vast demand for Shariah-compliant fixed income investments in the market. Furthermore, factors such as setting up guidelines for standardization of Sukuk documentation, for the purpose of reducing the cost of issuance for small and medium enterprises, are worthy initiatives that should be contemplated to facilitate more issuance. As the cost of Sukuk documentation is becoming a major hurdle for potential issuers, many SMEs are uncertain of their ability and capacity to issue Sukuk with reasonable cost, compared to conventional bonds which are commercially undesired in the local market, but which are more economical to issue. Reducing the cost of Sukuk issuance is an essential aspect to assist Sukuk issuance to contribute to corporate finance in Saudi Arabia.

Eleven participants believed that Sukuk development would help absorb the excess liquidity in the market, and increase the depth of corporate finance in the Saudi market. They also contend that Sukuk would help employ and guide the inexperienced local investors to invest in a reliable and stable long-term fixed income investment asset class, as an alternative to the dominant high-risk equity market. Although equity investment is the most widespread asset class in Saudi Arabia, the role of Sukuk as an alternative method of investment is gaining ground since the establishment of the Capital Market Authority (CMA) in 2005 to bridge the gap access to long term investment products.

Portfolio diversification is becoming an important concept, with the awareness campaign being lead by the CMA. One key Sukuk investor believes that the introduction of Sukuk is a new investment channel for the general local investment community, beyond the conventional channels such as deposits, Murabahas, real estate and equities, and is an important method to diversify corporate finance in Saudi Arabia (CMA, 2009).

Three interviewees expressed their concern over the limited types of Sukuk structures in the market, due to legal constraints as most of the Saudi debt market is dominated by the Istithmar Sukuk of SABIC and SEC. Hence, participants are interested in diversifying the Sukuk structures, in terms of secured versus unsecured, by presenting to investors a share of the Sukuk's underlying assets along with the cash flows and the proportionate risk embedded within the ownership. According to Moody's (2010), "By the end of 2009, only 4% of the US\$ 32 billion worth of Sukuk we rate represented secured "asset-backed" Sukuk".

In addition, two participants pointed out that while terms such as Mudarabah, Musharaka, and Ijarah are extensively employed, the legal Sukuk structure behind the phrase needs to be examined individually to understand the return and risk that are implicit. Nonetheless, there was consensus that the development of a real "asset-backed" Sukuk should be in parallel with the development of the regulatory framework in Saudi Arabia. One banker felt that Ijara and Mudaraba are the best structures for Sukuk because of their operational simplicity. Another investor stressed that when evaluating Sukuk for investment

opportunities, the type of Sukuk is not really of concern as oppose to other important factors such as the Sukuk credit, return and liquidity.

Five interviewees highlighted the dearth of lawyers and legal firms with sufficient Shariah knowledge and background. The presence of such proactive institutions would boost the volume of successful Sukuk transactions. They suggested that legal firms should develop teams that included Shariah expertise. Unfortunately, most Ijara Sukuk structures that have been issued in other markets are not acceptable from a Shariah perspective in Saudi Arabia.

What is the outlook for Sukuk in Saudi Arabia? What factors are likely to encourage further issuances? Should Sukuk be traded on the Tadawul?

Most of the participants agreed that the outlook for Sukuk issuance in the Kingdom is positive due to the demand manifested in the high bid-to-cover ratio in most Sukuk offerings; albeit this would depend on factors such as the lack of legal framework and issues relating to enforceability and the precedence of Sukuk holders as creditors in the case of default. Other factors that could affect the Sukuk market dynamics include liquidity of the existing Sukuk, government participation in issuing Sukuk, lack of skilled human resources, standardization of Shariah interpretations and innovative product development.

Ten interviewees regarded the outlook of Sukuk to be positive as it is becoming the choice for the long-term mode of financing for corporates. Saudi Arabia still tracks Malaysia, the largest Sukuk market in the world. This is largely due to structural issues such as lack of robust regulatory framework, the lack of secondary trading and differences in Shariah interpretation. Most participants believed that the Saudi authorities need to take collaborative measures to overcome these legal shortcomings and facilitate development of the Sukuk market in the Kingdom.

There was a consensus among interviewees that there is massive scope for Sukuk progress in the Saudi Arabian market, at a time when banks do not offer long-term funding and there are some difficulties in obtaining short-term credit. As the Saudi government is engaged in huge infrastructure projects worth thousands of millions of riyals, Sukuk instruments could offer suitable solutions for projects that address the risk of an asset-liability mismatch, boosting their issuance. As the previous Sukuk issuances in Saudi Arabia were issued for period of five years, the 2010 SEC Sukuk issuance was the first to be for a tenor for seven years, exceeding the average maturity. In addition, the imminent mortgage law in Saudi Arabia is likely to improve growth in the mortgage market, which would spur Sukuk issuance in order to facilitate future lending.

The demand for Shariah compliance financial products is a major feature of the Saudi market and a key driver of the growth of the Islamic finance industry. This factor has convinced most issuers of the investment case for issuing Sukuk to meet their long-term financing needs, instead of approaching banks to meet their financial obligations. However, the shortage of liquidity in the Sukuk market through secondary trading remains a concern. The more liquid the Sukuk market becomes the deeper and more efficient the market will be, and new classes of institutional investors will have access to the market for asset allocation.

However, three interviewees were seriously concerned about the absence of a modern and standardized Sukuk regulatory framework to accommodate the rapid evolution of the market. Thus, it is absolutely vital to establish an updated legal system in coordination with the Capital Market Authority (CMA), Saudi Arabian Monetary Agency (SAMA), Ministry of Finance and Ministry of Commerce and Industry, in participation with professional Shariah bodies and market practitioners.

One respondent stressed the need for market makers for secondary trading on Tadawul, as investors wanting to trade large blocks of shares could be price disadvantaged. He urged that the Tadawul should be the ultimate platform for such trading, rather than the current OTC system where large blocks are traded off exchange to avoid disadvantageous

prices. He also underlined the fact that the secondary market activity is significantly slow, with the Tadawul registering only nine trades during Q2 2010 (Tadawul, 2010).

The interviewees welcome the creation of the electronic trading platform for Sukuk and bonds by the CMA in June 2009 to increase the volume of trading. This method would help improve the efficiency and transparency and decrease the cost of trading. The other benefits of the platform include a central database for all fixed income trades for better price discovery and liquidity. This could pave the way for attracting global investors to invest in the Saudi Sukuk market. The platform, they agreed, could serve as a source of data and information for improved transparency.

One banker thought that market conditions will determine the Sukuk pricing, which consequently will affect the yield expectations, discouraging new issuance or at least will alter the yield make up and market expectation of spreads. He also stressed that the interest rate would have a major impact on Sukuk issuance as it changes the variability between fixed coupon Sukuk and variable ones.

For the secondary market to really take off there has to be a critical mass of issuances. This would attract more investors in the market. Consequently, the more Sukuk issuance there are from various sectors and industries, the better it is for market prospects. Sukuk could offer a feasible investment asset class for low-risk profile investors. The interviewees commended the liberalization of the financial market in Saudi Arabia by the CMA and stressed that the newly-established investment brokerage and investment companies should promote Sukuk for a better risk-return profile for their institutional and individual investors.

These interviewees also predicted that Tadawul trading will eventually create an active and regulated secondary market in the Kingdom. Issuers would also be willing to tap the market for new issuances, as transfer of ownership; tradability and market liquidity can be facilitated at minimum transactional cost. This cornerstone initiative will improve the longer-term sustainability of the Sukuk market. However, one investor thought that it is

crucial that the CMA should force issuers (as part of the issuing process requirements) to have their Sukuk rated before they are listed on the market. He believes that this would help investors in their due diligence process, whenever they contemplate such an investment, and would encourage active trading by institutional investors.

How significant is the rating of Sukuk in determining whether to invest?

On the question of how significant is the rating of Sukuk in determining whether to invest, nine respondents commented that rating is significant due to the fact that it helps drive the risk based capital calculation and provide great comfort. One respondent thought that rating is not the only element that can provide comfort to investors; and that rating would be necessary if the issuer wants to tap the international market. He highlighted the recent Saudi Binladin Sukuk issuance undertaken locally without any rating, which was oversubscribed two and a half times, and he thought this was fine as long as the liquidity is available and the subscription is local or even regional.

All interviewees agreed that the credit rating background in Saudi Arabia is still lagging global standards. Nevertheless, Sukuk rating is becoming a necessity in order to obtain a favourable pricing, longer tenors of Sukuk and to diversify the investors' base. And with the recent regional Sukuk defaults or near defaults, seven interviewees were demanding that all material factors, like the assets cash flow and credit risk, be scrutinized for more accuracy in the evaluation of creditworthiness, and to limit the possibility of default.

Eight interviewees were anxious over the fact that Saudi Arabia does not compel Sukuk issuers to obtain ratings, which is exposing investors to poor and unprofessional due diligence. As most institutional investors, including some government entities, do not invest in unrated Sukuk, rating is becoming a major stipulation for institutional investors and sophisticated HNWIs. However, seven participants acknowledged that rating by global rating agencies is a costly process for Saudi SMEs who are interested in issuing Sukuk. However, the non-existence of a credible local rating agency is affecting Sukuk

market prospects. Four interviewees suggested that the CMA create a rating agency for the purpose of determining the creditworthiness of all listed companies with the potential to issue debt instruments.

Many of the interviewees also suggested the use of the Islamic International Rating Agency, to fill the gap due to the absence of a local rating agency, and due to the importance of ratings for providing the market with an independent and objective opinion on the companies' financial status and creditworthiness.

Some interviewees pointed out that the Shariah proscription on Gharar (uncertainty) and Maysir (speculation) ought to provide additional comfort for investors against any hidden or miscalculated market risk. Hence, all the interviewees recommended that rating agencies should work together with the Shariah scholars to provide potential investors with a solid standardized Sukuk structure. For this reason, Shariah scholars and rating agencies need to develop a standard mechanism for a unified approach on Sukuk with credit enhancement mechanism. All participants felt that it is better to develop a feasible credit rating methodology, to take into account the distinguishing characteristics of Shariah-compliant Sukuk, and to decrease the cost of the rating process.

Rating services are offered by major global agencies where Moody's focuses on default rate, while Standard & Poor's focuses on the issuer's ability and willingness to meet financial obligations, which are becoming capital market requirements to grant the mandatory Sukuk ratings (Islamic Finance Asia, 2008).

Have actual and potential Sukuk defaults in other GCC countries been detrimental to Sukuk issuance in Saudi Arabia?

In a reply to my semi-structured interview question on have actual and potential Sukuk defaults in other GCC countries been detrimental to Sukuk issuance in Saudi Arabia, three out of eleven respondents commented that regional defaults had a relatively small impact on the Sukuk investment prospects in Saudi Arabia.

The defaults on the other hand could affect Saudis who have exposure to them. In this respect there could be negative fallout. As the Sukuk market had been grown rapidly in recent years, there are fears among interviewees that the market has largely been untested and untried especially in Saudi Arabia. They also raised questions about how regional courts will judge Sukuk default cases, and their promptness on resolving the investors' claims. They worry that the general Sukuk structures have been unclear, causing more confusion within the nascent Sukuk market and that is why Sukuk have been paying higher yield because they have never been put to the test of default and restructuring.

Seven interviewees were certain that the forthcoming defaults and restructurings will change the entire Sukuk market picture. They questioned how secure Sukuk are, as most Sukuk structures are asset-based, and not asset-backed. Most Sukuk were structured as a loan based on the issuer's balance sheet.

However, participants were expecting that demand will be for local Sukuk laws to adopt a more developed regulatory framework, and jurisdictions like English law in order to secure and protect their rights, with clear ownership of the underlying assets on asset-backed Sukuk. English law is the preferred legal jurisdiction for many Islamic financial transactions because of its ability to incorporate freedom to contract, which too is a classical component of Islamic law. Hence, initiating mandatory legal agreements with major global jurisdictions for legal enforcement of only Shari'a-compliant cross-border business contracts such as Sukuk would address most of the enforceability concerns.

Seven interviewees presumed that the Sukuk default was caused by the global financial crisis rather than the Sukuk structure or other factors such as the business model or cash flow projections of the issuer.

All the interviewees agreed that unless Saudi Arabia develops its bankruptcy laws and regulatory framework, the Sukuk prospects will be threatened by potential defaults during a downward economic cycle. They remain optimistic about the future for Saudi Sukuk.

Despite the problems of issuers in some GCC countries, no corporate Sukuk issued in Saudi Arabia have hitherto defaulted.

Conclusion

The Semi-structured interview chapter has given valuable insight into the respondents' opinions on different issues related to the prospects of Sukuk in Saudi Arabia. The strong oversubscription in the third Saudi Electricity Company Sukuk issuance in 2010 shows an unprecedented interest, even during the local credit squeeze (Mohammed Dawood, 2010).

Some of the techniques used started with a verbal discussion followed with written semi-structured questions for focused feedback from interviewees.

I was conducting open-ended questions and discussions with each interviewee depending on his/her professional background and perspective, for the purpose of providing an opportunity for more a constructive outcome. Interviews explored different facts and areas of interest in which many observations were raised and addressed.

The established questions in the semi-structured interview for investigation were very stimulating in creating a focused dialogue, targeting specific aspects of Sukuk with the opportunity for additional impromptu questions raised through the conversations.

Chapter Nine

Corporate Perspectives on Sukuk Issuance: Findings from a Focus Group Comprising Saudi Finance Directors

Introduction

I arranged a mini-seminar to conduct focus group discussions with some corporate finance directors on the subject of the recent trends and expectations for corporate Sukuk in Saudi Arabia. This discussion was intended to highlight the opportunities and challenges facing Sukuk origination in the Saudi debt market. It is concluded that the Saudi Arabian debt market has great potential due to the massive investments planned by the government and private sector.

The Saudi government has been proactively engaging in a strategic plan to modernize its capital market environment in order to help fund part of its vast infrastructure projects and to stimulate its economy. Saudi Arabia is implementing a long-term fiscal and monetary strategy to diversify its economic base away from oil to non-oil industries. The aggressive government diversification scheme has helped the non-oil sector become a strategic force for growth in recent years.

Saudi Arabia has earmarked to invest a stimulus package of SAR 1,500 billion (\$400 billion) to be spent during the 2008-13 period. In 2009, the government sector grew by 4.0%, and the private sector expanded by 2.5% (NCB, 2010). It is expected that the role of the nascent debt market will gradually increase in securing financing for a considerable proportion of these super-sized projects, particularly the market-driven demand for Sukuk instruments.

However, Saudi banking credit remained restrained in 2009, as total bank credit declined for the first time since 2001. The global financial crisis did affect local investment sentiments, with rising concerns over private corporate defaults and loan losses. The debt restraint, which distressed well known Saudi family companies AlGosaibi & Bros

(AHAB) and Saad Group in 2009, shocked the Saudi credit market and shook corporate confidence levels not only locally but also regionally. This has compelled Saudi banks to stiffen their corporate lending to minimize their exposure to corporate credit in all areas.

Bank lending to business in Saudi Arabia was flat in 2009 after average growth of 27 percent between 2004 and 2008, according to Jadwa Investment (Gamble and Bourland, Jadwa, 2010). Although, there is expectation that there could be a boost in Saudi bank lending over the next few years due to the Kingdom's abundant liquidity, banks will continue to conduct risk averse lending policies, and thus will not be able to meet the growing demand from corporates during the expected economic recovery.

Sukuk are now emerging as one of the most viable financing options for companies seeking to raise long-term Shariah-compliant capital for their business expansion, due to the fact that they are liquid and can be securitized and traded. Sukuk issuers desire Sukuk over bank loans because they can offer Sukuk with favourable terms, even though they pay, in advance, higher initial fees for structuring, legal and arranging costs. However, Sukuk over time are thought to be less costly than other modes of financing.

Some Saudi government officials have already started promoting the debt market including Dr. Mohammed Al-Jasser, the governor of the Saudi Arabia Monetary Agency (SAMA), who expects substantial growth for Sukuk. SAMA has confirmed that it is working with other government agencies to develop the Sukuk's regulatory framework so that it may become an important source of financing, allowing diversification away from government funds which, until now, have dominated the financing of the mega-infrastructure projects (Parker, Arab News, 2010).

The Saudi Arabian economy is the largest in the region and together with the fact that the Kingdom has the largest proven oil reserves in the world; Saudi Arabia is a member of the Group of Twenty (G20), comprising the major advanced and emerging economies in the world. Saudi Arabia accounts for more than 45 percent of the GDP of the Gulf Cooperative Council (GCC) countries.

The recent structural reforms and economic diversification policies have increased the size of the economy and added substantial dynamism. Given the enormous size of the mega-projects in Saudi Arabia, banks loans and government funding will not be able to meet all the requirements for funding, hence Sukuk are rising as an additional and alternative source of financing.

This chapter mainly constitutes of two parts. The first part is to evaluate the different promising potential industries in Saudi Arabia that could employ Sukuk for financing; and the second part is based on the findings of a focus group discussion with Saudi corporate directors on the evolution of corporate Sukuk market in Saudi Arabia.

The Potential for Sukuk in the following industries: Infrastructure, Construction, Transport, New Economic Cities, Real Estate and Mortgage Market and Telecom.

Saudi Arabia has a rapid developing market for infrastructure finance. Plentiful liquidity and a fast growing young population are the major drivers commanding infrastructure projects for economic diversity. According to the International Monetary Fund (IMF), the total medium-term project investments in industries like real estate, infrastructure, oil and gas stood at SAR2,370 billion for 2009 in Saudi Arabia (Al-Fil 2009). Infrastructure financing growth in Saudi Arabia is one of the highest in the region with SAR1 trillion-worth of projects in the pipeline.

The Saudi Arabian government has earmarked SAR113 billion worth of projects, mainly for transport and utilities. According to BMI's Q1 2010 Saudi Arabia Infrastructure Report, the outlook for the Saudi infrastructure sector remains positive. The government is fully committed to providing support to all major infrastructure projects. The government even stepped in and took over some mega-projects that had difficulties in raising financing, such as the Ras Al-Khair Independent Water and Power Plant (IWPP), and the Saudi Land-Bridge Rail Project, and pumped in the required funding (BMI, 2009).

However, alternative sources of funding are desperately needed to diversify the funding base and Sukuk are the most appropriate instruments to meet this challenge. As stated in table 9.1, the long-term lending of local banks to listed companies fell in 2008-9. In contrast growth in demand for Sukuk and long-term debt offered by the Public Investment Fund (PIF), the investment arm of the Ministry of Finance, has grown steadily.

The Saudi stock market is divided into 15 sectors. The bulk of the borrowing was undertaken by companies undertaking major expansions, such as petrochemicals, telecom and electricity, which represents 82 percent of the current outstanding long-term (more than one year) debt of listed companies, according to Jadwa report (Gamble & Abdulkarim, Jadwa 2010).

Table 9.1: Long-term debt of listed companies

Source of Funding	Total (SAR Billion)			Share		
	2007	2008	2009	2007	2008	2009
Local banks	107	121	130	52.3 %	45.1 %	39.2 %
Sukuk and bonds	35	43	57	17.1 %	16.0 %	16.7 %
PIF	11	24	36	5.3 %	8.8 %	11.0 %
Foreign banks	14	24	31	6.9 %	9.1 %	9.3 %
Ministry of finance (2 loans to SEC)	28	28	28	13.9 %	10.6 %	8.6 %
Loans from partners	2	16	26	1.1 %	6.1 %	7.8 %
SIDF	7	12	12	3.5 %	4.3 %	3.8 %
Others	-	-	10	-	-	3.6 %
Total	204	268	330			

Source: (Jadwa, 2010)

The potential for construction in Saudi Arabia is massive and based on substantiated demand in the most populous country in the Gulf. The Saudi Arabian construction sector grew by 3.9 percent in real terms in 2009, supported by real demand from the indigenous population (Sfakianakis, 2010). Mr. John Sfakianakis, Chief Economist at Saudi Fransi Banque, explained that the outlook for Sukuk is dependent on many factors including liquidity, government participation in issuing Sukuk, and Shariah standardization. The outlook is positive in light of the Saudi government's spending to modernize its infrastructure, and to revive and grow the national economy.

According to the Saudi Arabian Ministry of Commerce and Industry, there will be a deficit of 160,000-to-200,000 housing units per year (Saudi Gazette, 2010) over the next few years.

The building and construction sector is one of the largest sectors of the Saudi economy and it has been undergoing strong growth in recent years. The main building and construction activity is driven by government spending, private-sector developers and foreign direct investors. Government projects are in general the biggest sponsor of most of the Saudi construction projects, where SAR1,064 billion worth of projects are underway, while a further SAR375 billion worth of projects are in the pipeline for 2008 through 2013. Housing, education and transport industries are the principal recipients of these investments. However, for construction companies who are eager to diversify their sources of financing, it is absolutely pivotal for them to explore the opportunities of raising funds through Sukuk (Thompson, MEED, 2010).

Major Saudi real estate developers such as Dar Al-Arkan and Binladin Group have issued Sukuk to tap into the local debt market to raise long-term finance for their real estate activities. Private contractors are in desperate need of securing funding for their operations; however, banks have reached their limits of lending for most private companies and even some listed companies. Contractors in Saudi Arabia are facing stiff lending conditions and a deteriorating equity market deterring them from going for IPOs, and facing a great need to diversify their financing sources in order to survive.

Sukuk are the best candidates to fill this gap and offer long-term financing solutions, because they are demanded by most local investors due to the fact that they are Shariah compliant liquid asset class. “Considering Saudi local market conditions and investor’s preferences, the development of commercial paper in Saudi will enable corporate short-term funding requirements to diversify away from bank sources,” according to SABB.

Saudi Arabia has been investing heavily in developing the capacity of its transport sector to meet the rapid demand and expansion, with an expected expenditure of SAR 375 billion over a period of ten years starting in 2010 (Arabian Business, 2010).

The transport system is poised to be transformed into an advanced network with state-of-the-art logistics hubs at ports, aviation related facilities, and four railway projects such as the 950km Jeddah-Dammam land-bridge at a cost of SAR26.2 billion; a 2,000km rail line running north to south with a track construction cost of SAR2.7 billion; a monorail system connecting the holy city of Mecca to nearby holy sites at Mina, Arafat and Muzdalifah for a cost of SAR6.4 billion; and a high-speed railway between Mecca and Medina for a cost of SAR26.2 billion (BMI, 2009).

As Saudi Arabia enjoys a strategic location, the country has the capability of growing to become one of the world's foremost logistics hubs. The Saudi General Authority of Civil Aviation (GACA) is engaging in an investment strategy of SAR2.5 billion to modernize domestic airports. GACA is also investing extensively in major airport expansion projects at Medina and Jeddah at a cost of SAR9 billion and SAR26.3 billion respectively (MEED, 2010). Funding most of these extra-large transport projects will be based on a public-private partnership basis. These planned long-term projects will need Shariah-compliant long-term financing instruments such as Sukuk. Saudi Arabia is changing its financing strategy by tapping new sources of funding like Public-Private Partnerships, Sukuk, and Private Equity funds, showing that the market can offer more than merely bank loans and government funding.

The new concepts of economic cities and tourism have emerged to offer hundreds of millions worth of new mega-projects and economic, educational, tourism and technology hubs for many other industries as part of the government's attempts to diversify its economic base away from oil. King Abdullah Economic City (KAEC), Medina Knowledge Economic City (MKEC), Jazan Economic City (JEC) and Hail Economic City (HEC) are expected to host five million people, and generate 1.3 million jobs.

KAEC and MKEC started construction in 2006 and 2009 respectively. KAEC is one of the five economic cities and the single largest private sector-led project in Saudi Arabia with an estimated cost of SAR 132 billion and the biggest port in the world costing SAR 23 billion (Njeri, 2010). However, it is extremely critical to make sure that these economic cities have the potential to succeed because if they fail, Sukuk (assuming that they would feature in the financing mix) could encounter potential defaults which would derail them and shake investors' confidence in the Sukuk market. These economic cities are considered by some investors and experts to be too ambitious and may face serious financing challenges. If these economic cities choose Sukuk for funding, their success or failure could impact on the future of the Sukuk market.

Selling and leasing land will be the main source of income for these economic cities. However, financing the economic cities will come from different sources like IPOs, bank loans and debt instruments. Due to the magnitude of the investment in these cities, relying on IPOs and local bank financing only, will not suffice to meet the requirements of financing for their development. Hence, Sukuk could provide different types of funding for investors. The economic cities could easily promote securitization in Saudi Arabia and offer better innovative Sukuk structuring (Moabi, Thomas, Markovski, Alexnader, and Fyfe, QNB Capital, 2011).

Due to the fact that there is a considerable demographic evolution with a high rate of population growth and improving personal disposable income, spurred by higher oil prices, demand for commercial and residential real estate units has soared. However, the real estate market remains substantially under-developed due to the absence of a mortgage law. Naveed Siddiqui (2010), chief executive officer of Capitas Group International, assesses the mortgage market in Saudi Arabia will reach SAR120 billion between 2010 and 2020. Furthermore, there is a vast potential for Sukuk to help finance mortgage lending through asset-backed Sukuk for mortgage companies, as most banks have reached their lending limits. Saudi banks have been experiencing a widening asset-liability maturities mismatch since they started mortgage lending largely on the basis of

personal loans, and Sukuk could address this issue by supplying long-term funding solutions (Siddiqui, 2010).

However, the imminent launch of the Saudi mortgage law is expected to accelerate the lending evolution in the local mortgage market, which still lags behind regional and international markets. As of Q4 2010, less than 1 percent of all Saudi homes purchased are financed by mortgages, against 7 percent in neighbouring United Arab Emirates and 66 percent in the United States, Deutsche Bank (Fattah, 2010).

The Saudi Arabian government funding strategy is to promote long-term financing through corporate Sukuk and bonds to diversify the funding sources in the market. The debt market is rising to become one of the best options for long-term financing, with Sukuk to be the most favoured by investors. Therefore, Sukuk sales are expected to be boosted by the imminent mortgage law to secure imperative long-term financing for mortgage companies. Dr. Mohammed Al-Jasser, Governor of SAMA, reiterated that “it will be a qualitative jump in the way we finance housing in the country and the way we use financial instruments that are linked to the housing market” (Hall, Bloomberg, 2010).

Dr. Al-Jasser expects the new mortgage law in Saudi Arabia to increase the sales of Sukuk and corporate bonds for more efficient debt market. He also anticipates that the demand for corporate Sukuk and bonds will increase gradually amid maturing government bonds, which are held mainly by financial institutions, and which will be replaced with corporate Sukuk and bonds (Hall, Bloomberg, 2010).

This new mortgage law is anticipated to further develop Sukuk issuance in the Saudi market. Sukuk are expected to enable mortgage entities to facilitate their future lending business, while preserving a form of comfortable security over extended credit (Hijazi, Moody's, 2010). According to Deutsche Gulf Finance (DGF), a Saudi Islamic mortgage company, research suggests that the Saudi Arabia housing industry will need 1.2 million more homes by 2015. This research also estimates that once the legislation is adopted, it will spur a new demand of 55,000 units per year (Arnold, 2010). A DGF source has

confirmed in our focus group discussion that mortgage companies are interested in tapping the debt market to raise long-term funding to finance their clients, and Sukuk are being seriously considered.

The telecom industry is one of the biggest industries in Saudi Arabia that is experiencing a vast expansion with sustainable demand (Thompson, 2010). Mobile communications subscriptions increased 26 percent y-o-y to 45.3 million in 2009 at a penetration rate of 177 percent in 2009. BMI expects this rate to increase to 205 percent by 2013. Internet penetration is only 42 percent, and broadband usage only 8 percent, although these figures are projected to double by 2013 (BMI Tech Knowledge, 2010).

However, most telecom companies have reached their bank credit limits and seek different methods for long-term borrowing, and the nascent Sukuk instruments have the ability to satisfy such requirements. In addition, all telecom companies have abundant tangible and intangible assets and could offer good opportunities for innovative financial engineering for securitization purposes based on Sukuk.

Saudi Telecom Company (STC), Etihad Etisalat Company, Zain Saudi Arabia and Etihad Atheeb Telecommunication Company are all listed communication companies that provide telecommunication services in Saudi Arabia. They are all keen on expanding their market share in Saudi Arabia and globally, to counter local competition, price pressure and market saturation, with an emphasis on the provision of high-speed broadband. Although, some of these telecom companies enjoy a healthy liquidity ratio, it is expected that these companies will soon tap the emerging Saudi debt market by selling Sukuk and saving their liquidity for unexpected challenges.

With the aggressive STC global expansion strategy since 2007 in countries such as Malaysia, Indonesia, India, Turkey, South Africa, Kuwait and Bahrain, it has been gradually tapping the debt market. STC invested about SAR 7.6 billion representing STC's share in the Sukuk and bank facilities of Binariang GSM. The Sukuk return was used to finance Binariang's acquisition of the outstanding shares of Maxis, to increase

Binariang ownership in Maxis to 100%. The transaction of the deal started with a refinancing of a bridge loan to fund the buyout of Maxis Communication in June 2007 by STC. The refinancing of the bridge loan encompasses for nominal value of medium term notes commercial paper (Collective Senior Sukuk), junior debt (Junior Sukuk) and syndicated term loan facility (Global, 2009).

The Junior Sukuk is the largest hybrid instrument issued by a Malaysian corporate and subscribed mainly by the Saudi Telecom Company (Islamic Finance News, 2008). The unprecedented growth in the Saudi telecom industry has opened opportunities for Sukuk in this fertile industry. With a liquid and buoyant domestic debt market, Sukuk issuance is expected to be initiated soon by more telecom companies to meet their projected expansion, extending and upgrading their existing network to gain bigger market share.

Given the enormous capital cost needed, and the long-term nature of these mega-projects, there is immense potential for Sukuk to flourish in the market for their capacity to fund these ventures. Local Sukuk subscription never felt the heat of the global financial crisis, as all Sukuk issuance in the Saudi market have been oversubscribed. The emergence of the Sukuk market in the last few years in Saudi Arabia experienced healthy growth in H1 2010, at a time when Saudi banks are not lending due to high potential default of some local companies, even though they are flooded with liquidity. As the Saudi government is determined to launch its proposed infrastructure, transport, construction, and economic cities projects, developers will have to tap into the debt market favouring Sukuk for financing, due to substantial demand from local investors.

Insights of leading Saudi Corporate Finance Directors through the Focus Group Discussion.

I gathered a group of eight leading corporate directors who manage entities from different industries in Saudi Arabia. The objective was to exchange views on the subject of the recent trends and expectations of corporate Sukuk in Saudi Arabia, and to create an informed environment for frank dialogue and to encourage brainstorming to assess the potential and evolve solutions to the challenges facing the prospects for corporate Sukuk.

The corporate finance directors expressed their considerable interest in raising financing for their expansion or operations via Sukuk; however, they highlighted several factors that may affect their Sukuk issuance decisions.

I also managed to establish a conference call between the eight participants and the top management of some major Saudi Sukuk issuers to discuss their issuance experiences in SABIC, SEC and others. All eight directors also expected a surge in the flow of corporate Sukuk in Saudi Arabia, which could provide the entities with an ideal financing platform to grow and to seek new business opportunities. Three directors agreed that Sukuk was becoming an internationally-accepted debt financing instrument with a growing global appeal, as underlined by the growing number of Sukuk issuances and the increasing interest of foreign conventional investors in investing in the Kingdom.

“Sukuk and bonds issuance in the Middle East will range between 10 and 15 in 2010-11, with demand mainly from Saudi Arabia,” said Dr Mohamed Daud Bakar, managing director of Amanie Islamic Finance Consultancy and Education (Pasha, 2010). The Saudi Arabian Sukuk market is perceived to be the biggest potential Sukuk market in the region because of its high liquidity and demand for financing.

Five of the participants acknowledged that they have received encouraging gestures from the regulators for tapping into the local debt market, and to issue Sukuk or bonds. However they would like to see more transparency in the regulatory framework, and lower costs of debt issuance. In addition, they raised the issue of differences in the prevailing Sukuk structures, and the lack of standardization in Shariah interpretations amongst scholars, a factor which could deter investors.

“With this (Sukuk) debut issuance, SABIC is pleased to have led the way in opening up the non-equity capital market sector in the Kingdom. We are gratified that we were able to achieve our key objectives with this transaction, namely further development of the Kingdom’s capital markets and providing investors with greater investment choices, and the first step in diversifying of our funding sources,” said Mohammed Al-Mady, Vice

Chairman and CEO of SABIC (Golden, AMEinfo.com, 2006). This statement demonstrates the upbeat assessment and confidence in Sukuk and its growth prospects by top issuers such as SABIC.

Indeed the SABIC's CFO participated in the conference call with the focus group. He stressed that Sukuk is the most appropriate methods of financing for SABIC's expansion projects. SABIC is a pioneer in issuing Sukuk and it has been doing so since 2006 on an almost annual basis to fund its ambitious expansion plans. All Sukuk sales in Saudi Arabia have been substantially over-subscribed many times over. This shows the strong demand for Sukuk, particularly if issued by blue chip companies like SABIC and SEC.

SABIC's CFO also confirmed the corporation's intention to occasionally tap into the Saudi market through issuing Sukuk. The aim is to offer strategic investors more options to invest in SABIC; to fund the corporations' burgeoning growth and to demonstrate its responsibility to the national economic by helping to develop the local debt and capital market. "The time is appropriate (to issue Sukuk) because this is the time when the Islamic financial market is developing and secondly, liquidity in the Saudi riyal is abundant in the Saudi market," Chief Financial Officer (CFO) of SABIC Mutlaq Al-Morished told Al-Arabiya television (Galal, 2008).

This statement was made during SABIC's Sukuk offering at a time when several Gulf Arab borrowers cancelled corporate Sukuk offerings, because the situation in the global credit market made borrowing more expensive. This reflects the strengthening conviction that there is a healthy demand for Sukuk in the nascent Saudi debt market, even during times when there were Sukuk defaults or near defaults in regional markets.

All eight participants shared a positive outlook on the landmark 7-Year SEC Sukuk III, which they stressed would stimulate longer-term issuances in the market. They were relieved that the SEC Sukuk III was over-subscribed which to them indicated that demand for investment in Sukuk in Saudi Arabia is still robust, even during weakening regional demand. We also had a conference call with the SEC's Chief Executive Officer,

Mr. Ali Al-Barrack, who confirmed the electricity utility's intention to continue issuing Sukuk regularly to meet the fast growing demand for electricity in the local market. SEC might even tap into the global debt market.

“The Saudi Electricity is different. Its Sukuk are for the financing of productive projects...there is strong support by the government to the company but the government does not guarantee these Sukuk,” (Souhail, Reuters, 2010).

Mr Al-Barrack highlighted the changing nature of structuring financing for the electricity utility - before 2006 it had been 100% bank financing and by 2009, bank borrowing accounted for only a quarter of its financing, while Sukuk made up 49 percent. This supports the optimism of the recent trends of increasing tapping into the Sukuk market by corporate directors due to their positive expectations.

The participants were indeed bullish about the future of the Sukuk market and they expect the larger Sukuk issuance for the next few years to come from the government-owned companies such as the SEC, SABIC, and other major public entities.

The Saudi Hollandi Bank (SHB) Sukuk raised much discussion about the urgent need for Saudi banks to address the asset-liability mismatch dilemma on their balance sheet via issuing Shariah-compliant funding instruments, such as Sukuk. The consensus was that banks are under a lot of pressure to provide long-term lending as the economy expands, and this will make them look for long-term borrowing. They added that most Saudi banks are facing a debt maturity structure that can be mainly solved by issuing Sukuk for restructuring purposes.

In a conference call, SHB's Chairman, Mubarak Al-Khafrah, pointed out that their Sukuk offering was met with an overwhelming demand with 4-to-1 bid-to-cover ratio which enabled the bank to secure a lower pricing than its earlier price guidance. SHB's ability to raise Tier II capital to comply with Basel II requirements is a strategic development in adding a new feature to Sukuk issuance. Dr. Bernd Van Linder, Managing Director of

Saudi Hollandi Bank, said the successful closing of the SHB Sukuk could only have happened with the active participation of local investors, such as government institutions, insurance companies, investment and money market funds and financial institutions (Odiabat, AMEinfo, 2010).

In a conference call with the participants, Dar Al-Arakan Real Estate Development Company Managing Director, Mr. Abdullatif Al-Shalash, concurred that Sukuk would unlock the latent of the mortgage market in Saudi Arabia following the adoption of the mortgage law. More Sukuk structures, he added, are becoming standardized in terms of cost and time compared to conventional bonds, making Sukuk cheaper and faster to issue. Most of the discussion hovered around the fact that Sukuk can provide the best Shariah-compliant solutions for real estate developers who are looking to raise long-term financing at a lower-cost to balance their asset-liability mismatches.

To what extent is the Saudi debt market able to help publicly listed corporates in growing sectors such as Petrochemicals, Cement, Energy, Utilities, Telecommunication, Industrial, Construction, Real Estate and Tourism to diversify their funding base using long-term Sukuk and away from short-term banks loans, remains to be seen. The participants agreed that the Saudi debt market can offer suitable Shariah-compliant solutions such as Sukuk, Commodity Murabaha and Mortgages. They pointed to the successful SAR700 million 9-month Murabaha Sukuk issued by the Saudi Binladin Group in July 2010 through a private placement in the Saudi debt market. The Binladin Sukuk offering was met with enormous demand, reaching 2.5-to-1 bid-to-cover ratio (Carey, Bloomberg, 2010).

The unique nine-month tenor and structure of the Binladin Sukuk is an innovative form of short-term Sukuk, which implies a new-found flexibility of Sukuk structures. This issuance is the first Sukuk offering in Saudi Arabia with a tenor of less than three years. Most corporate entities are in need of short-term financing solutions to accommodate some of their financing needs, as banks are implementing more restrictions on their lending. Hence, short-term Sukuk are anticipated to attract more investors due to their

short tenor and lower risk compared to the equity market. Walid Khoury, CEO of HSBC Saudi Arabia, stressed that “having led Saudi Binladin Group’s debut Sukuk issuance in 2008, we are proud to have brought their second Sukuk issuance to the market as well. This Sukuk contains several important innovations and provides a well-structured short term, domestic investment alternative to investors in Saudi Arabia” (Bloomberg, 2010).

All the participants agreed that the Saudi and global Sukuk market would receive a major psychological boost if Saudi ARAMCO, the world’s largest oil producer and exporter, were to tap the market with a debut Sukuk offering. Indeed, Saudi ARAMCO reportedly is planning to go to the market at some stage to raise funds through a debut Sukuk issuance. The participants deem a Saudi ARAMCO Sukuk would be an important statement of policy intent by the Saudi government to provide more confidence to the Sukuk market in Saudi Arabia.

Saudi ARAMCO has already mandated different financial institutions for their possible Sukuk transaction, and it is only a matter of time before it comes to the market. Most of the participants agreed that Saudi ARAMCO’s need for financing for its huge expansion programme to increase oil production capacity to meet spiralling global demand, will streamline the Sukuk market for sustainable growth. Saudi ARAMCO’s interest in Sukuk origination is a demonstration of the government’s interest in sharing its planned growth with the public by issuing Sukuk, as they consider the local debt market to be a strategic option to benefit local investors.

Conclusion

Sukuk origination in Saudi Arabia has an enormous potential to grow. But if this mode of financing is to become a mainstream method of financing for Saudi companies, then the rules and regulations relating the Saudi debt and capital market need urgently to be boosted and further developed. Corporate debt sales from Saudi Arabia have reached SAR 12.1 billion by May 2010 from SAR 750 million in the same period in 2009, according to Bloomberg (Carey, Bloomberg, 2010).

When banks in Saudi Arabia tightened their corporate lending during the global financial crisis in 2008-2009 and struggled with their credit exposures against defaults or potential defaults, Sukuk issuance became a viable option for some entities to meet their financial commitments. However, we should also expect potential defaults for some corporate Sukuk in the local market, as these local industries are largely exposed to the global financial crisis. In the focus group discussion, the participating Saudi corporate finance directors saw Sukuk as ideal liquid instruments, because they can offer versatile benefits for long-term financing by mobilising resources at a reasonable rate for issuers. For the bank providing a loan, the return is higher than that for Sukuk, which is logical, as the bank loan represents capital which is tied up for 5 years, whereas the Sukuk is liquid if there is an active market, giving more flexibility to the Sukuk holders.

However, many of the participants thought it is critical to standardize the process of Sukuk issuance, to create an efficient process for tapping the local debt market and to activate the secondary market. In addition, finance directors of Saudi corporates are buoyant about the abundant liquidity in the local market, and expect corporate Sukuk issuance to flourish. They emphasize the need to develop the Sukuk market with more transparency and availability of historic trading data for easier decision-making by the potential issuers. Finance directors feel that more Sukuk sales are needed to increase the depth and breadth of the local market.

Chapter Ten

Summary and Conclusions

Introduction

The Sukuk market in Saudi Arabia has grown substantially in recent years due to the vast financing requirements necessitated by a proactive public spending policy. Sukuk have emerged as an alternative financing instrument for companies and an investment asset-class for investors for source of funding and investment portfolio diversification purposes.

Saudi Arabia contributed more than 14 percent to the total value of Sukuk issued globally in 2010. At the same time, the global Sukuk market had reached a record SAR 180 billion (\$47.78 billion) in 2010, according to a report published by Kuwait Finance House (KFH) Research Limited (2010) (El Asser, IFIS, 2011).

Sukuk are more attractive as long-term financing and investing instruments over conventional bonds in Saudi Arabia due to their Shariah-compliance, which is a key characteristic of the Saudi market, in addition to their securitization and liquidity features. Unlike traditional bonds, Sukuk are backed by tangible or intangible collateral and give undivided ownership of the underlying assets for an agreed period for investors. In contrast, conventional bonds represent a promise by issuer to repay the loans to investors.

Moreover, Sukuk are emerging as attractive financing solutions in Saudi Arabia in a financial market in which bank lending has become restricted because of the impact of the credit crunch and global financial crisis and the volatile equity global and local markets. Sukuk issuers agree in most cases to grant a return to investors in the form of payments, which are linked to the cash flows generated from the underlying assets for which capital is being raised.

Presenting at the Bonds and Loans Middle East Conference in Dubai, UAE in June 2011, Jarmo Kotilaine, the Chief Economist of National Commercial Bank of Saudi Arabia, emphasized the expanding Sukuk role perceived by issuers and investors as a key player in financing the huge economic development in Saudi Arabia. He thinks that Sukuk are competently placed and could serve as a bridge between the large pools of capital in the Kingdom and the immense infrastructure investment requirements provided mainly by the government (Kotilaine, 2011).

Sukuk involve the securitization of real assets and raising financing to produce economic activities on the basis of sharing risk and rewards. Hence, leveraging is contained to the underlying value of the assets, which means that there has to be a high degree of transparency and disclosure in the Sukuk issuance process.

Innovators have developed numerous Sukuk structures which are proving to be flexible and sustainable to meet future market growth. However, some Sukuk structures such as Mudaraba and Musharaka because the principal payment is guaranteed at par, have recently been regarded not to be Shari'a-compliant in the eyes of mainstream Shari's scholars especially by a prominent scholar such as Sheikh Muhammad Taqi Usmani. These remarks have had major repercussions in the global Sukuk market which caused the fast-growing Sukuk market to slow down for a few months. Even though, the Sukuk market is regaining its momentum, these remarks could have had a permanent damage to a niche market.

Although, these remarks could have some ground, the Maslaha Mursala principle which is in the welfare and interest of the community and society, should have been taken into consideration when evaluating Sukuk structure contracts. The principle of Maslaha could be used to resolve the suitability of a precise Shari'a interpretation in such subjects as the use of a particular Sukuk-based structure. It is a fact that there is a disagreement between different fiqh schools regarding Maslaha. It is important to reach a mutual understanding over their relevant rulings on the contemporary controversial Shari'a-compliant financial

instruments. And this is displayed in the recognition of Maslaha which Shari'a intellectuals predominantly promote as an important value and objective of the Shari'a to reach greater consensus in the best interest of public like. Imam Malik was a leading proponent of supporting Maslaha as one major source of Shari'a, as he represents interest that have not been explicitly mentioned in other secondary Shari'a sources.

Corporate Sukuk have attracted much attention in Saudi Arabia. In the first chapter of this research, I have put the following questions: 'What is the recent trends and expectations for corporate Sukuk in Saudi Arabia?', 'What are the barriers in the way of corporate Sukuk development?', 'Why is the raising of funds via the banking financing system and the equity market not enough?', and 'What are the barriers to an active secondary Sukuk market?'

My analysis in response to the above questions started with arguing the case for the enormous potential for corporate Sukuk in Saudi Arabia. This research suggests a phenomenal growth in the interest in the Sukuk market in Saudi Arabia from both issuers and investors. I have identified that the regulatory system is the main barrier for corporate Sukuk development. However, the Saudi regulators have come a long way towards establishing a modern securities market infrastructure, although there is much to be done in adopting a complementary legal infrastructure.

Most analysts describe the debt market in Saudi Arabia as a sleeping giant. As the Sukuk market is witnessing a substantial growth, this research analyses many of the issues surrounding the Sukuk including the ethical principles, products, regulatory framework, and market dynamics.

The economic growth in Saudi Arabia due to high oil proceeds led to a rapid expansion of business activities inspired by landmark economic reforms. Prior to the 2008-9 global financial crisis there had been huge demand for financing mainly driven by the private sector to fund mega-projects in Saudi Arabia. However, following the global financial

crisis, demand was mainly driven by the public sector. The preference of both sectors has clearly been for long-term Shariah-compliant financing solutions such as Sukuk. Innovation in Sukuk origination has included structuring, securitization, and the enhancement of creditworthiness (Watheeqa, 2010).

Funding from banks was never a problem due to the abundant liquidity because of the vast proceeds from high oil prices prior to the 2008-9 global financial crisis. This included Shariah-compliant bank financing and lines of credit. Traditionally, banks have been the leading provider of financing in Saudi Arabia, accounting for around 82 percent of the funding requirements of Saudi companies (Al-Jazira Capital Economic Report, 2010). Small and Medium enterprise were keen on tapping the booming equity market as banks do not favour lending to these enterprises because of their limited disclosure and transparency. That is why the debt market in Saudi Arabia was never genuinely considered as an option for funding.

The Sukuk market started gaining momentum only when major public corporate entities like SABIC and SEC started issuing Sukuk on almost an annual basis to diversify their funding base. Sukuk became the most popular Shariah-compliant corporate financing instruments since 2006 in Saudi Arabia. According to the City of London economic research (2008), the debt market in Saudi Arabia is in great need of development because of the following:

- financial services can offer an alternative source of revenue,
- the need to mobilize local assets for domestic development,
- the need to develop sophisticated financial engineering for funding large infrastructure development,
- the need to meet a growing demand for Shariah-compliant financial products.

The Sukuk market in Saudi Arabia has the capability of becoming the biggest Sukuk market globally underpinned by the Kingdom's strong economy due to budget surpluses from high oil prices accumulated in recent years. The Saudi government has been conducting prudent and counter-cyclical fiscal policies to support its economic activities.

The vast government spend is intended to accelerate the economic recovery in Saudi Arabia which consequently would increase income-per-capita for its citizens enabling them to invest in the developing capital market.

Furthermore, there has been a growing need to create Shariah-compliant investment products for the growing investor base for portfolio and source of funding diversification purposes. Reforming the capital market in Saudi Arabia is an imperative task in the next few years to offer investors the option of diversifying their investment portfolios away from the dominant equity market. The challenge of competing with regional capital markets to attract its local investors is a battle that has to be won for a sustainable economic growth and provide jobs to a rapidly-growing population where more than half is less than 20 years old.

In order for the Sukuk market in Saudi Arabia to develop, the government has to modernize the regulatory and legal framework, corporate governance and open the market to wider direct foreign participation for better integration with the global markets. The rising need for long-term financing has increased substantially as the government has embarked on a comprehensive investment plan to modernize its infrastructure and to launch mega-projects in various industries. Public and private corporate entities are interested in financing their investment via long-term funding to address the risk of an asset-liability mismatch on their balance sheet. Shariah-compliant Sukuk is ideal for raising much needed liquidity for corporate entities.

The imminent adoption of a mortgage law in Saudi Arabia will increase the need for Shariah-compliant long-term financing instruments due to the fast growing population and the increasing demand for housing units. Residential mortgage finance in Saudi Arabia represents only 1-3 percent of gross domestic product compared to 66 percent and 71 percent for the United States and United Kingdom respectively. The long-awaited mortgage law is also expected to facilitate mortgage lending and consequently revitalize the residential real estate market. The anticipated recovery of the real estate industry will further improve the market prospects for Sukuk origination in Saudi Arabia, especially by

real estate development companies and mortgage providers (Al-Jazira Capital economic report, 2010).

Many corporate entities from different industries in Saudi Arabia are realizing the importance of long-term funding in the aftermath of the 2008-9 global financial crisis and the need to diversify sources of funding to minimize risk. And due to the important fact that Sukuk is a Shariah-compliant financing instrument, it is critical to develop and activate the Sukuk market in Saudi Arabia by greater institutional and retail issuance in the primary market and trading in the secondary market.

In 2010, there has been a relative active build-up of corporate Sukuk in the pipeline with nearly SAR11 billion in total values to take advantage of the liquidity excess in the domestic market (Emirates 24/7, 2011).

Since the establishment of the Capital Market Authority (CMA) in Saudi Arabia in 2003, the Authority has been engaging in a package of reforms to strengthen the domestic debt market, of which an important development was the launch of the Sukuk electronic trading platform by the Tadawul Saudi Stock Exchange. This landmark step has made Sukuk trading and pricing easier and more efficient for a functional primary and secondary debt market. The new Sukuk platform is predicted to give confidence to institutional, retail, pension funds and Takaful insurance companies for Sukuk investments with straightforward transfer of ownership, tradability and greater market liquidity with minimal amount of transactional fees.

Saudi Arabia is growing to be the second largest Sukuk market in the Gulf Cooperation Council (GCC) in recent years with 94.4 percent of Compound Annual Growth Rate (CAGR) in Sukuk issuance with a value of SAR 21 billion during 2003-to-2007. However, the Sukuk market in Saudi Arabia was affected by the global financial crisis and declined 67 percent in 2008 to SAR7 billion and issuers avoided the domestic debt market waiting for the crisis to subside (Kotilaine, NCB Capital, 2009).

The Sukuk market rebounded in 2009 and 2010 with SAR11.6 billion and SAR 11 billion of issuances respectively due to the improvement of investors' confidence. The Oil and Gas sector has overshadowed the Sukuk market in Saudi Arabia with 34.3 percent of total value of Sukuk issued during 2003-to-2010, followed by the Power and Utilities sector which accounted for 25.7 percent of total Sukuk issued over the same period. The market is dominated by corporate issuances in Saudi Arabia, accounting for 82 percent for total Sukuk issued in the last five years. This market segment registered a CAGR of 116.7 percent over 2004-to-2009 reaching a value of SAR 4.5 billion. In spite of this progress, it is deemed that the Sukuk market in Saudi Arabia is under-penetrated and its potential is yet to be unlocked with Sukuk financing representing merely 0.7 percent of the Saudi Arabian GDP (Al-Jazira Capital economic report, 2010).

The Long-Term Outlook for the Sukuk Market in Saudi Arabia

The long-term outlook for the Sukuk market in Saudi Arabia is bright for the following reasons:

i) Firstly, according to table 10.1, major companies such as SABIC and SEC were enjoying cheaper funding by issuing Sukuk compared to bank loans prior to the 2008-9 global financial crisis. The evidence shows that Sukuk have lower debt servicing costs than bank loans. For instance, the cost to SABIC and SEC five year bank loan is a minimum of SIBOR (Saudi Inter-Bank Offered Rate) +75 basis points (bps) whereas the service charge for the five year Sukuk is SIBOR + 40bps (35 basis points less) and SIBOR + 45bps (30 basis points less) on the lower side respectively. Yet, upfront arrangement fees are likely to be higher for Sukuk than bank loans due to their legal and Shariah advisory requirements. Since then, banks in Saudi Arabia have become more conservative by tightening their lending standards and implementing very restrictive and selective lending guidelines in addition to increasing their loan rates. Hence, cautious lending has been dominating the domestic credit market in Saudi Arabia on one hand, and an unstable equity market has deterred private corporates from raising funds in fear of low valuation. Subsequently the profile of Sukuk profile as a viable substitute for banks lending and equity market has been increasing. These factors have encouraged corporate entities to look for alternative sources of financing such as Sukuk.

However, table 10.1 shows that a mid-size privately-owned real estate entity, Bin Laden Group, which has issued Sukuk, looks to have higher servicing costs than bank loans. For instance, the cost to Bin Laden Group for five year bank loans is a minimum of SIBOR+ 1.5 percent on the lower side whereas the service charge for five year Sukuk is 7 percent fixed. Yet, the increasing quantity of longer duration investment projects launched in Saudi Arabia in recent years, has promoted Sukuk as the best candidate to meet such long-term funding requirements to face the risk of asset-liability mismatch on companies' balance sheets. Furthermore, some companies are reaching their borrowing limits as banks are limited in the amount of the money they can lend to single clients to mitigate exposure risk to a single client.. Also, some companies would like to tap into the debt market on their own favourable terms even if the cost of financing is higher than bank loans to promote the company's profile and to make available different sources of financing.

Table 10.1 Bank loans rates compared to Sukuk coupon rates in Saudi Arabia:

Company	Bank Loans Rates	Sukuk issue	Year issued	Coupon (Annual Rates)	Term (years)
SABIC	3M SIBOR+75bps-1.25%	SABIC 1	2006	3M SIBOR+40bps	5
		SABIC 2	2007	3M SIBOR+38bps	5
		SABIC 3	2008	3M SIBOR+48bps	5
SEC	3M SIBOR+75bps-1.25%	SEC	2007	3M SIBOR+45bps	5
Bin Laden Group	3M SIBOR+1.5-2.5%	Bin Laden Group	2008	7% fixed	5

Source: (SAMA and Tadawul, 2010)

ii) Secondly, the Sukuk market prospects if fuelled by the growing demand for Shariah-compliant products due to the increasing wealth within the investment community in recent years in Saudi Arabia. The high oil proceeds after years of high oil prices have enabled investors to stipulate Shariah-compliance for investing in financial instruments. This also goes beyond the vast Muslim community to include conventional investors

seeking, for risk exposure diversification purposes, better underlying asset quality and eager to be exposed to Saudi credit in particular.

iii) Thirdly, the Saudi government is committed to a SAR1,875 billion economic stimulus development plan for infrastructure projects between 2008 and 2013, and some of these investments are expected to be financed via Sukuk. This enormous investment program is the highest by a G20 member in terms of GDP per capita for stimulating its economy and maintaining sustainable recovery by pumping massive investment in different industries (Kotilaine, NCB Capital, 2009).

In addition, the looming Saudi mortgage law that is anticipated to enhance Sukuk offering for long-term funding for real estate institutions to address the risk of asset-liability mismatch on their balance sheet. Also, the new mortgage law is a Shariah-compliant legislation which means that all related financing should be Shariah-compliant.

Defining the terms of mortgages, how they are designed, how they are granted, how companies are licensed and how procedures will be enforced are the major components of the new law. The adoption of the mortgage law will stimulate demand for long-term funding which in turn will help increase possibilities for mortgage-backed securitization.

iv) Fourthly, Sukuk are the only liquid long-term Shariah-compliant financing instruments as most long-term projects are challenged by the risk of assets-liability mismatch because of the short-term bank lending. Modest long-term bank lending is accessible, hence Sukuk as long-term financing instruments are capable of addressing this risk. Long-term Sukuk will solve this issue and help establish a sustainable financing source for corporate entities borrowing for long-term projects.

v) Fifthly, Tadawul has launched an advanced Sukuk electronic platform in June 2009 to facilitate Sukuk trading. This has made Sukuk trading easier and more efficient. Thus, it is expected that the volume of Sukuk trading over time will increase especially for institutional and retail investors due to its liquidity features. The Tadawul platform is

supposed to facilitate ownership transformation, minimize transactional cost, improve pricing transparency and disclose critical historical trading data for investors.

According to Jadwa (2009), the Sukuk platform is expected to bolster the Sukuk market with more supply from issuers and demand from investors in Saudi Arabia:

- Predictability and portfolio diversification: Sukuk have the capacity in diversifying investment portfolios instead of the dominant and risky stock market.
- Problems raising finance from traditional sources: with the global 2008-9 financial crisis, banks have tightened their lending for risk aversion policy amid potential defaults. Also, the equity market became too volatile making IPOs unappealing. Hence, Sukuk have the potential to be the promising alternative source of funding.
- Balance sheet mismatches: with the growing long-term projects in Saudi Arabia, the need is emerging for long-term borrowing by companies to meet the asset-liability mismatch on their balance sheets.
- Healthy Sukuk pipeline: many companies have showed interest into tapping the debt market in Saudi Arabia by issuing Sukuk

Challenges Facing the Sukuk Market in Saudi Arabia

Nonetheless, the Sukuk market in Saudi Arabia is confronted with several serious challenges that could have negative consequences unless they are dealt with on a systematic basis. Some of these challenges are as follows:

i) The Kingdom needs to massively improve and modernize the legal framework for Sukuk and debt market origination to facilitate securitization and true underlying assets sale for better asset-backed Sukuk structure. There must also be strict implementation of corporate governance regulations to boost transparency and bolster disclosure, since these are essential requirements to avoid any potential default in the future. The default and near default of regional corporate Sukuk has shocked the markets and the same scenarios could be repeated if the similar legal hurdles are not tackled and default procedures are not implemented.

ii) Second, the lack of an active secondary trading market in Saudi Arabia is constraining the positive possibilities of the Sukuk market where the traded value of Sukuk was less than 0.1 percent of the equity traded value in 2010 (Moabi, Thomas, Markovski, Alexnader, and Fyfe, QNB Capital, 2011). I have addressed the issue of the barriers for an active secondary Sukuk market which lacks liquidity due to limited trading of Sukuk which is discouraging institutional and retail investors from actively engaging in the Sukuk market. Almost all investors in the domestic Sukuk market prefer to own the Sukuk on a hold-to-maturity basis due to the lack of Sukuk offerings in the market. There should be a market trading education agenda adopted by regulators to help activate the secondary market by encouraging corporates and investors through awareness campaigns to tap into the debt market. The absence of liquidity in the secondary market could pose a serious risk and if this situation continues Sukuk could be labelled as illiquid instruments. A total of 55 Sukuk transactions had been executed since the launching of the Tadawul Sukuk electronic platform in June 2009 and until the end of 2009 only SAR 27.4 million of certificates were traded for SABIC I, SABIC II, SABIC II, SEC I and SEC II issuances.

iii) Regulators must organise seminars and conferences about the Sukuk market in the Saudi Arabia to educate potential issuers and investors. Most businesses in Saudi Arabia are family-owned and lack the necessary debt market knowledge and experience. Potential issuers in Saudi Arabia need to be exposed to seminars to highlight the importance of Sukuk as long-term Shariah-compliant instruments to diversify their financing base. These seminars should promote the Sukuk market by increasing the potential issuers' experience and knowledge of Sukuk structuring, issues, legal, and listing requirements. The average potential Sukuk issuers in Saudi Arabia have limited understanding of the fixed income asset class.

iv) Scarce human resources expertise with background in the related fields of finance, Shariah and legal matters is a major obstacle in the Sukuk market in Saudi Arabia. Integrating these three key disciplines for serving the Sukuk market is a challenge that

will need a long-term solution by providing the necessary training courses and educational programs for all stakeholders.

Conclusion

The local debt market is an essential pillar for the capital market in Saudi Arabia as long-term liquid instruments for issuers and investors. Sukuk are becoming important financing instruments away from the dominant bank loans and IPOs. Furthermore, unlike bank loans, companies can raise funding with favourable terms via issuing Sukuk for longer tenures.

For investors, Sukuk are favoured as liquid and low-risk investment instruments which are flexible because they can be securitized and become tradable. Individual investors in Saudi Arabia have limited investment channels and have most of their life savings invested in the high-risk equity market or illiquid real estate markets. Institutional investors such as banks and insurance companies and quasi-government agencies greatly need to invest long-term and liquid instruments in order to meet their long-term liabilities, especially to replace the maturing Saudi Government Developments Bonds (SGDBs) being issued in the early 2000s. Hence, developing a mature, liquid and low-risk debt market would help individual and institutional investors in asset allocation and provide portfolio diversification.

In recent years, the government has been proactively enhancing and modernizing its debt market with a strategy to upgrade and expand the country's economic infrastructure to reduce its extensive dependence on hydrocarbon-related sectors. Hence, developing the debt market in Saudi Arabia became a top national economic priority. The government's liberalization policies in the debt market to increase the investors' confidence and boost investments for a sustainable economic recovery after the 2008-9 global financial crisis, has been an essential force into promoting the Sukuk market.

However, it is imperative to widen the breadth and depth of the Sukuk market to unlock its true potential.

In the semi-structured interviews conducted, investors and bankers along with representatives from different major stakeholders in Saudi Arabia agreed that they were optimistic about the future development of the debt market in the Kingdom, especially the Sukuk market. This optimism centred on several Sukuk market dynamics including competitive pricing, the innovation of Sukuk structures, the risk characteristics of the underlying assets, purchase undertaking, currency preference and the promising potential role and contribution of Sukuk in national economic development.

The interviewees concurred that pricing, a wide range of structures, the risks associated with the underlying assets, the importance of the purchase undertaking, currency preference were the most important considerations in the decision-making process relating to Sukuk issuance. They agreed that more Sukuk would widen the choice of investment asset classes for diversification purposes, and that the outlook for Sukuk issuance in the Kingdom is positive due to the great demand manifested in the high bid-to-cover ratio in most Sukuk offerings.

In a focus group where I gathered eight corporate directors who manage several entities from different industries in Saudi Arabia, the consensus was that the number of corporate Sukuk originations would increase over the next few years because of the high liquidity in the local markets which needed investment outlets. They agreed that Sukuk are ideal instruments to provide long-term financing at reasonable and competitive pricing. However, they warned that it is critical to standardize the process of Sukuk issuance for an efficient process for tapping the local debt market.

Saudi Arabia is before a valuable window of opportunity to advance further its Sukuk and bond status as the prospects for the emergence of a regional financial market across the GCC countries emerge. Furthermore, the Saudi Sukuk market has been growing significantly in recent years and has the ability to turn out to be a key source of funding for corporate entities in order to diversify their funding sources.

Demand for Sukuk in Saudi Arabia has surged in recent years with the growing liquidity from government agencies, pension and mutual funds, financial and insurance institutions and retail investors. This makes local debt risk very appealing. Most listed and private corporates in Saudi Arabia are demanded by their shareholders to conduct their business in a Shariah-compliant way. Not surprisingly more institutional investors are turning to investing in Sukuk issued by blue chip corporates such as SABIC and SEC due to the fact that they have a high credit rating from global rating agencies, which in turn boosts their confidence in investing in Sukuk.

The equity market in Saudi Arabia is the dominant part of the capital market. As such domestic investors have no choice but to invest in this high-risk asset class. The limited investment channels in the Saudi Arabian capital market had compelled investors to focus on the equity market which created an equity bubble between 2003 and 2006. This bubble erupted in February 2006 causing the vast majority of investors to lose life savings in an equity market that has not recovered up to now. That is why the capital market in Saudi Arabia is in acute need of a vital and liquid Sukuk market to assist in asset allocation and portfolio diversification for risk minimization purposes.

The crucial development of the Sukuk market will result in the development of a long-term Shariah-compliant assets class that will help institutional investors to manage their liquidity.

Developing a vigorous and liquid capital market with Sukuk as the main instrument is imperative for Saudi Arabia. Local issuers that plan to expand globally and go cross-border in their issuance will have to be able to deal with any upheavals and knock-on effects in the regional or international markets.

Appendix I

“Semi-Structured Interviews with Major Sukuk Investors’ Companies”

Company Name: _____ Date: _____

Representative Name: _____ Potential Sukuk: Investor or Banker

1. How important is the Sukuk pricing?

Explain why: _____

2. How important is the Sukuk Structure & the underlying assets for investors in case of default?

Explain Why: _____

3. How important is the risk of the Sukuk underlying assets?

Explain why: _____

4. How important is the Purchase Undertaking?

Explain why: _____

5. How important is the Currency Preference?

Explain why: _____

6. How can the issuance of Sukuk contribute to corporate finance in Saudi Arabia, and what types of Sukuk are best suited to the requirements of Saudi Arabian companies?

Explain why: _____

7. What is the outlook for Sukuk in Saudi Arabia? What factors are likely to encourage further issuances? Should Sukuk be traded on the Tadawul?

Explain why: _____

8. How significant is the rating of Sukuk in determining whether to invest?

Explain why: _____

9. Have actual and potential Sukuk defaults in other GCC countries been detrimental to Sukuk issuance in Saudi Arabia?

Explain why: _____

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Transliteration Table

Arabic Consonants

Initial, Unexpressed medial and final:

ء	'		د	d		ض	d		ك	K
ب	b		ذ	dh		ط	t		ل	l
ت	t		ر	r		ظ	z		م	m
ث	th		ز	z		ع	'		ن	n
ج	j		س	s		ع	gh		هـ	h
ح	h		ش	sh		ف	f		و	w
خ	kh		ص	s		ق	q		ي	y

GLOSSARY OF ISLAMIC TERMS (Howladar, 2006)

adl	A trusted and honourable person, selected by both parties to a transaction. Somewhat analogous to a trustee
amana/ amanah	Literally means reliability, trustworthiness, loyalty, honesty and is an important value of Islamic society in mutual dealings. It also refers to deposits in trust, sometimes on a contractual basis
bai/ bay	contract of sale, sale and purchase
bai al-salam	Advance payment for goods. Whilst normally the goods would need to exist before a sale can be completed, in this case, the goods are defined (such as quantity, quality, and workmanship) and the date of delivery fixed. Usually applied in the agricultural sector where money is advanced for inputs to receive a share in the crop.
fatwa	an authoritative legal opinion based on the Shari'ah
fiqh	Practical Islamic jurisprudence. Can be regarded as the jurists' understanding of the Shari'ah
gharar	uncertainty in a contract or sale in which the goods may or may not be available or exist, also ambiguity in the consideration or terms of a contract – as such, the contract would not be valid
hadith	the narrative record of the sayings, doings and implicit approval or disapproval of the Prophet
halal	Permissible. In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (haram) by the Qur'an or the Sunnah. Barring these, all others are halal. An activity may be economically sound but may not be allowed in Islamic society if it is not permitted by the Shari'ah
haram	Unlawful. (see halal) Describes activities, professions, contracts and transactions which are explicitly prohibited by the Qur'an or the Sunnah
Hawala	Bill of exchange, promissory note, cheque or draft. A debtor passes on the responsibility of payment of his debt to a third party who owes the former a debt. Thus the responsibility of payment is ultimately shifted to a third party. Hawala is used in developing countries as a mechanism for settling international transactions by book transfers
ijarah/ijara	Lease, hire or the transfer of ownership of a service for a specified period for an agreed upon lawful consideration. An arrangement under which an Islamic bank leases equipment, a building or other facility to a client for an agreed rental
ijtihad	Literally effort, exertion, industry, diligence. As a legal term, it means the effort of a qualified Islamic jurist to interpret or reinterpret sources of Islamic law in cases in which no clear directives exist
istisna'a	A contract of sale of specified goods to be manufactured with an obligation on the manufacturer to deliver them on completion. It is a condition in istisna'a that the seller provides either the raw material or the cost of manufacturing the goods
maisir/ maysir	the forbidden act of gambling or playing games of chance with the intention of making an easy or unearned profit
mudaraba/ mudarabah	A form of contract in which one party (the rab-al-maal) brings capital and the other (the mudarib) personal effort. The proportionate share in profit is determined by mutual consent, but the loss, if any, is borne by the owner of the capital, unless the loss has been caused by negligence or violation of the terms of the contract by the mudarib. A mudaraba is typically conducted between an Islamic financial institution or fund as mudarib and investment account holders as providers of funds
mudarib	the managing partner or entrepreneur in a mudaraba contract (see above)
musharaka/ musharakah	An agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and maybe others. All

	providers of capital are entitled to participate in management but are not necessarily obliged to do so. The profit is distributed among the partners in a pre-determined manner, but the losses, if any, are borne by the partners in proportion to their capital contribution. It is not permitted to stipulate otherwise.
murabaha	A contract of sale with an agreed profit mark-up on the cost. There are two types of murabaha sale in the first type, the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase them and this is termed a normal or spot murabaha; the second type involves a promise from a customer to purchase the item from the bank and this is called murabaha to the purchase order. In this latter case, there is a pre-agreed selling price that includes the pre-agreed profit mark-up. Normally it involves the bank granting the customer a murabaha credit facility with deferred payment terms, but this is not an essential element
qard al hasana/ qard hassan	A virtuous loan in which there is no interest or mark-up. The borrower must return the principal sum in the future without any increase
rab-al-maal	the investor or owner of capital in a mudaraba contact (see above)
rahn	a mortgage or pledge
riba	Simplistically interest. Sometimes equated with usury, but its meaning is broader. The literal meaning is an excess or increase and prohibits the generation of income from money
salam	a contract for the purchase of a commodity for deferred delivery in exchange for immediate payment
Shari'a/ Shari'ah	in legal terms, the body of Islamic law as extracted by the mujtahids from the sources of law – the Qur'an and the Sunnah; however, the Shari'ah rules do not always function as rules of law as they incorporate "obligations, duties and moral considerations that serve to foster obedience to the Almighty"
Sukuk	participation securities; coupons; investment certificates
Sunnah	The way of the Prophet Mohammed (PBOH) including his sayings, deeds, approvals and disapprovals as preserved in the hadith literature. It is the second source of revelation after the Qur'an
takaful	A Shari'ah-compliant system of insurance based on the principle of mutual support. The company's role is limited to managing the operations and investing the contributions
Ummah	The community or nation. Used to refer to the worldwide community of Muslims
wakala	agency; an agency contract which generally includes in its terms a fee for the agent
Zakah/ Zakat	A tax that is prescribed by Islam on all persons having wealth above an exemption limit at a rate fixed by the Shari'ah. Its objective is to collect a portion of the wealth of the well-to do and distribute it to the needy. The way it is distributed is set out in the Qur'an. It may be collected by the state, but otherwise it is down to each individual to distribute the Zakat