

Research Highlights:

Structuring Forward Lease Sukuk In Islamic Capital Market

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The forward lease nature is normally a combination of ijarah and istisna' where the outcome will be in a form of tangible or intangible asset that can be the subject matter of business transactions. Many assets in the market can be designed based on forward lease such as airplane, ships, residential or commercial building, and the like. The forward lease is regarded as innovative structure with special feature that contributes significantly to the expansion and evolution of the Islamic finance market. Below discussion is briefly illustration on the concept of forward lease and its structuring in the Islamic capital market

Concept of forward lease

Al-ijarah al-mawsofah fi al-dhimmah or forward lease is defined as the sale of future benefits for spot payment. Alternatively, it can be termed as a salam contract for usufructs, whether the usufructs are derived from physical objects or from services. It is called ijarah fi al-dhimmah (rental (entailing) in obligation) because what is in the liability of the lessor is not a physical tangible asset, but a usufruct. (Ahmad Nassar, 2009). Hence, forward ijarah has the features of two contracts which are ijarah and salam and the combination of these two characteristic will produce what is called forward leasing. On the other hand, Abu-Ghuddah defines forward ijarah as the commitment from the lessor to make some usufruct available in the future which has

been thoroughly described, as is required in salam contract, in order to avoid any potential conflict that may arise in this regard. The usufructs can be derived from an object, like the rental of a car with certain specification, or it can also be derived from some human service like tailoring or teaching. (Abu Ghuddah, 2009). This definition gives a broader scope of sukuk structures, where it includes various areas of services, tourism, educations, health care and many others.

Diversity of forward leasing portfolio

Diversity of Sukuk Ijarah Portfolio

Ijarah has a diversified portfolio that makes it more viable. It is divided into leased asset and services, existing ijarah and forward. Therefore, ijarah can be divided into four (4) major categories, which are as follows:

- Certificates of ownership over usufructs of existing assets.
- Certificates of ownership over usufructs of an asset to be made in the future as per description.
- Certificates of ownership over services of a specified supplier.
- Certificates of ownership over services to be done in the future as per description (AAOIFI, 2010).

Type of Ijarah Sukuk	Description of Ijarah Sukuk
Certificates of ownership over the usufruct of existing assets (Existing asset)	These are documents of equal value are issued either by the owner of usufruct of an existing asset or a financial intermediary acting on behalf of the owner with the aim of leasing or subleasing this asset or to receive rental from the revenue of subscription. The holders of these certificates will become owners of the usufruct of the asset.
Certificates of ownership over services of a specified supplier (Existing services)	These are documents of equal value that are issued for the purpose of providing or selling services through a specified supplier (such as educational programmes in a nominated university) and obtaining the value in the form of subscription income, in which the holders of the certificates will become owners of the services.
Certificates of ownership over an usufruct to be made in the future as per description (Asset: forward lease)	These are documents of equal value issued for the purpose of leasing assets that the lessor is liable to provide in the future, whereby the rental is recovered from the subscription income in which the holders of the certificates will become owners of the usufruct of these future assets.
Certificates of ownership over services to be done in the future as per description (Services: forward lease)	These are documents of equal value issued for the purpose of providing or selling services through non-existing supplier with the description of the subject matter (such as educational programmes of a specific quality, schedule, duration, etc. without mentioning the educational institution) and obtaining the value in the form of subscription income. The holders of the certificates will become owners of the services.

Features of the sukuk issuance of forward lease structure

The structure of sukuk al-Ijarah al-mawsofah fi al-dhimmah whereby two portfolios of ijarah must be excluded which are the existing asset and the existing

services, as these represent a type of ijarah structure. Hence forward lease ijarah should be designed based on the other two portfolios which are future asset to be constructed or future service to be offered. At the initial step of sukuk issuance both assets do not exist.

The following are the steps involved in issuing sukuk al-Ijarah al-mawsofah fi al-dhimmah:

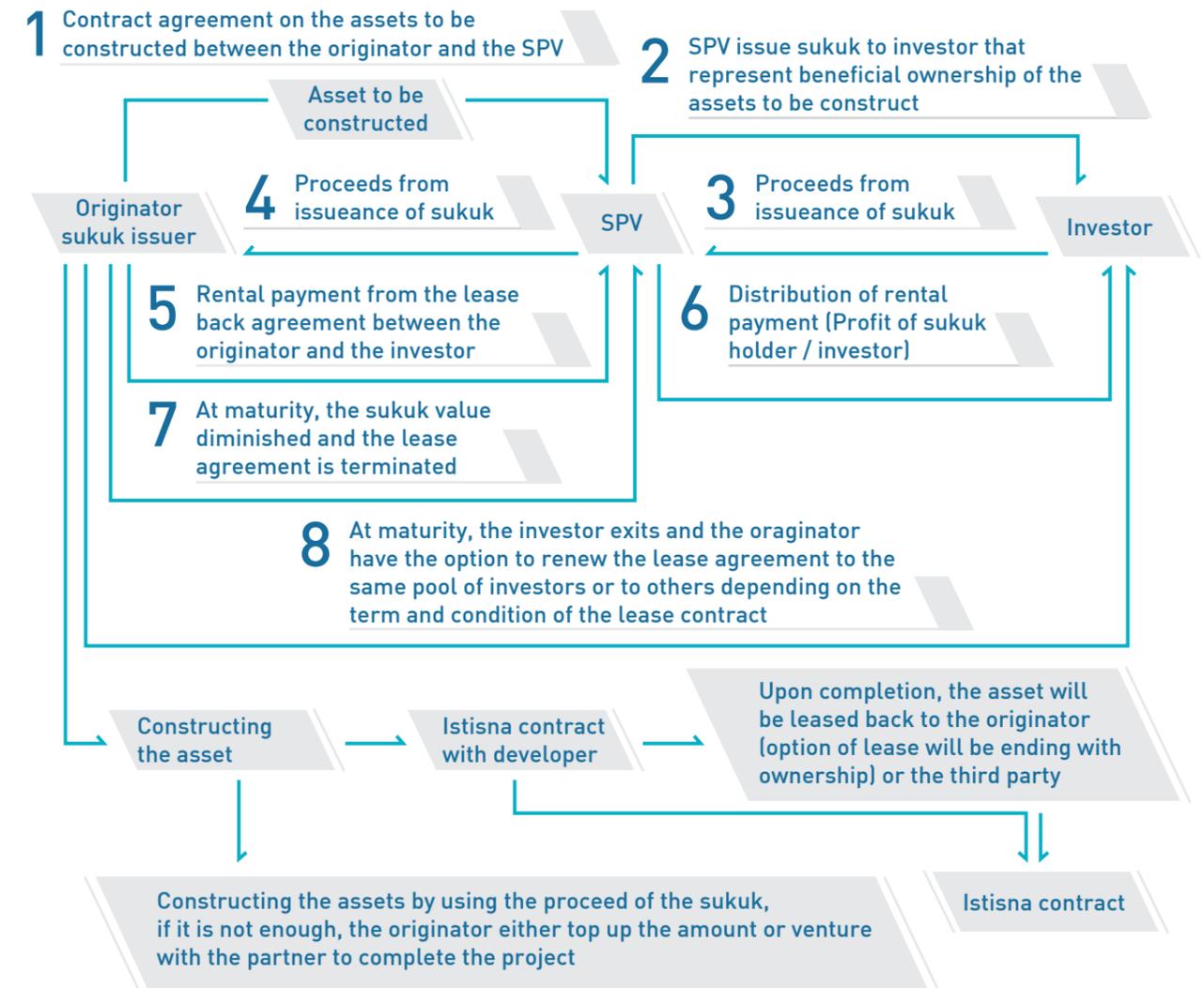
1. The sukuk issuance is based on forward lease: either asset to be constructed or service to be offer in the future.
2. The asset is to contracture based on a forward lease can be ending in the form of operating lease or designed based on financial lease upon completion.
3. The asset to be constructed can be university, hospital school, commercial tower or residential building, airplane, ship, train ect, based on the need to the issuer and investors.
4. The issuer or the investor can be government, or corporate, The sukuk holders can be institution

5. The parties involved in the sukuk issuance of typical sukuk will be present as well in the issuance of forward lease.
6. The sukuk issuance in forward lease will normally have two stages, the first stage is the istisna and the stage of ijarah.
7. Ijarah upon completion may be in form of operating ijarah or financial lease depending on the mutual agreement on the contracting parties.

The structure of forward lease sukuk (the structure is designed by the authors)

a) Ijarah structure

The proposed structure: Forward ijazah / lease sukuk overall structure



b) Istisna' structure

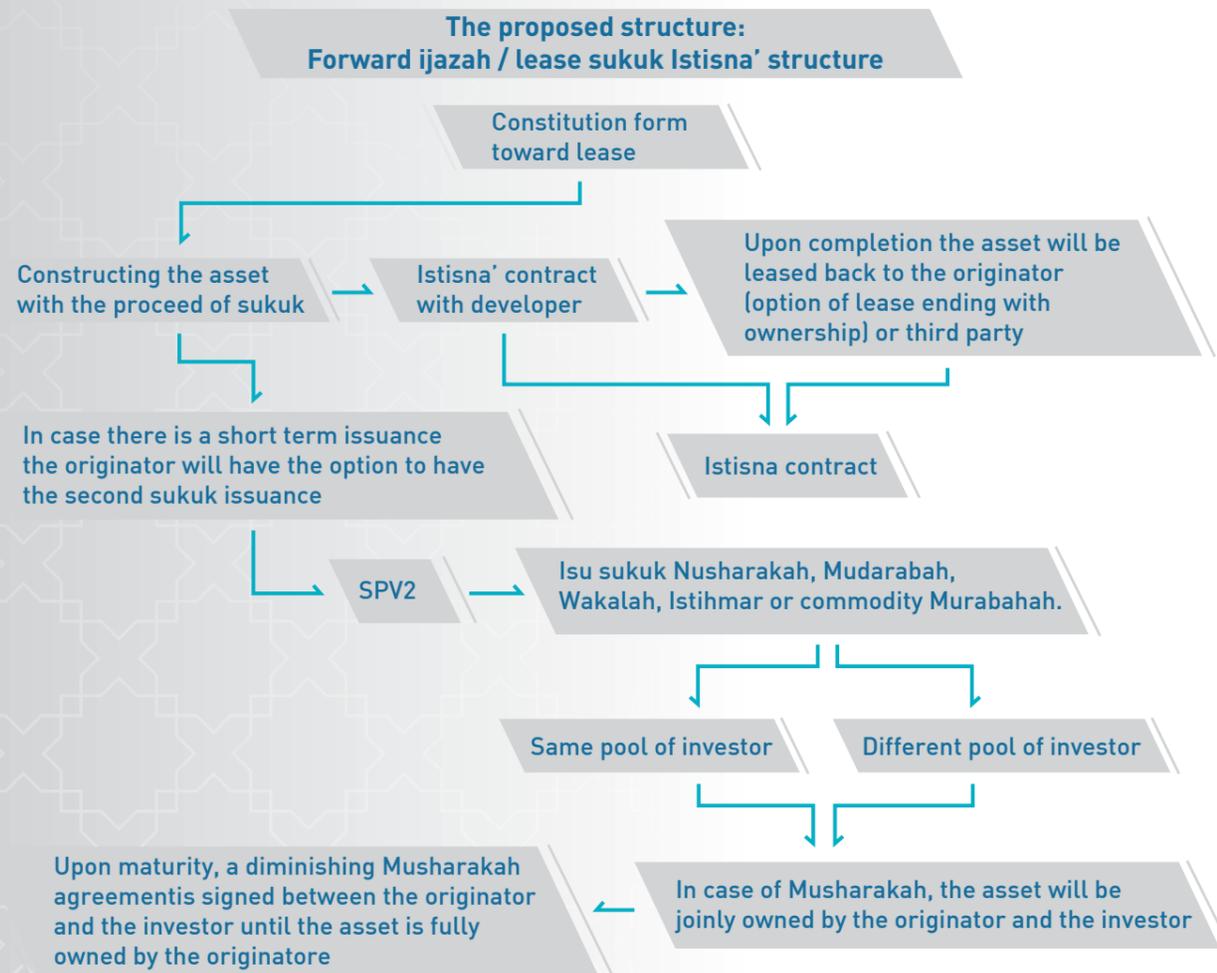


Illustration and process

The above structure shows how the forward lease is structured and the following steps should be considered in the structure

1. An SPV will be established.
2. Contract agreement is signed on the assets to be constructed between the originator and the SPV.
3. SPV issues sukuk to the investor that represents beneficial ownership of the assets to be constructed.
4. Proceeds from issuances of sukuk will be generated.
5. Constructing the asset such as commercial building or office tower or air plane.
6. Rental payment from the lease back agreement between the originator and the investor.
7. Distribution of rental payment (Profit of sukuk holder / investors)
8. At maturity, the sukuk value diminished and the lease agreement is terminated.
9. At maturity the investor exit, and the originator has the option to renew the lease agreement to the same pool of investors or to others depending on the terms and conditions of the lease contract.

As the construction of the asset the following steps should be observed:

1. Istisna contract agreement with developer.
2. Upon completion the asset will be leased back to the originator (option of lease ending with ownership) or to third party)
3. In case there is a short term issuance the originator will have the option to have the second sukuk issuance (Issue sukuk Musharakah, mudarabah, wakalah bil istithmar or commodity murabahah)
4. The same pool of investors can be used in the second issuance or different pool of investors can join the programme.
5. In case of musharakah the asset will be jointly owned by the originator and the second group of the investors.
6. Upon maturity a diminishing musharakah agreement is signed between the originator and the investors until the asset is fully owned by the originator.



“The same pool of investors can be used in the second issuance or different pool of investors can join the programme”

Conclusion

Forward lease sukuk represents an innovative structure in the Islamic capital market. It is based on ijarah which is regarded as one of the strongest shariah contracts that accommodate flexibility and innovation that suit the needs and of the issuers and investors, while satisfying the Shariah requirements in term of compliance. It is encourage to embark on sukuk issuance based on the forward lease because in addition to its important features, it is regarded as asset back structure with rich portfolio on the asset and the services, these features

makes the scope of the issuance in forward lease much wider. There is no doubt that there are some risks and Shariah issue associated with forward lease that should be addressed in take into consideration in the course of issuance. However the present short presentation did not capture those issues and challenges as its main focus is on introducing the structure, future research should look into different on forward lease in order to present to the financial market in very comprehensive manner.