CLIFFORD CHANCE

Briefing note

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Dissecting the UK Government sukuk

The ground-breaking sukuk issuance by the UK Government earlier this year, the first of its kind by a European sovereign state, seeks to position the UK as an international hub for Islamic finance and tap Shari'a compliant investors. In this article we go behind the scenes to uncover how the Clifford Chance team navigated previously undiscovered territory.

The global Islamic financial services market is estimated to be worth somewhere in the region of US$1.14 trillion. Its potential for continued growth has made it attractive to investors who are looking to take advantage of all the opportunities it presents. As a result, raising finance through Islamic financial instruments has become increasingly popular throughout the world.

July 2014 saw the first sovereign sukuk issuance in the United Kingdom. The UK government made its inaugural issuance with a £200 million sukuk due in 2019. The sukuk offer a competitive periodic distribution amount set at a rate of 2.036 per cent per annum. The issuance was very well received by investors and was heavily oversubscribed.

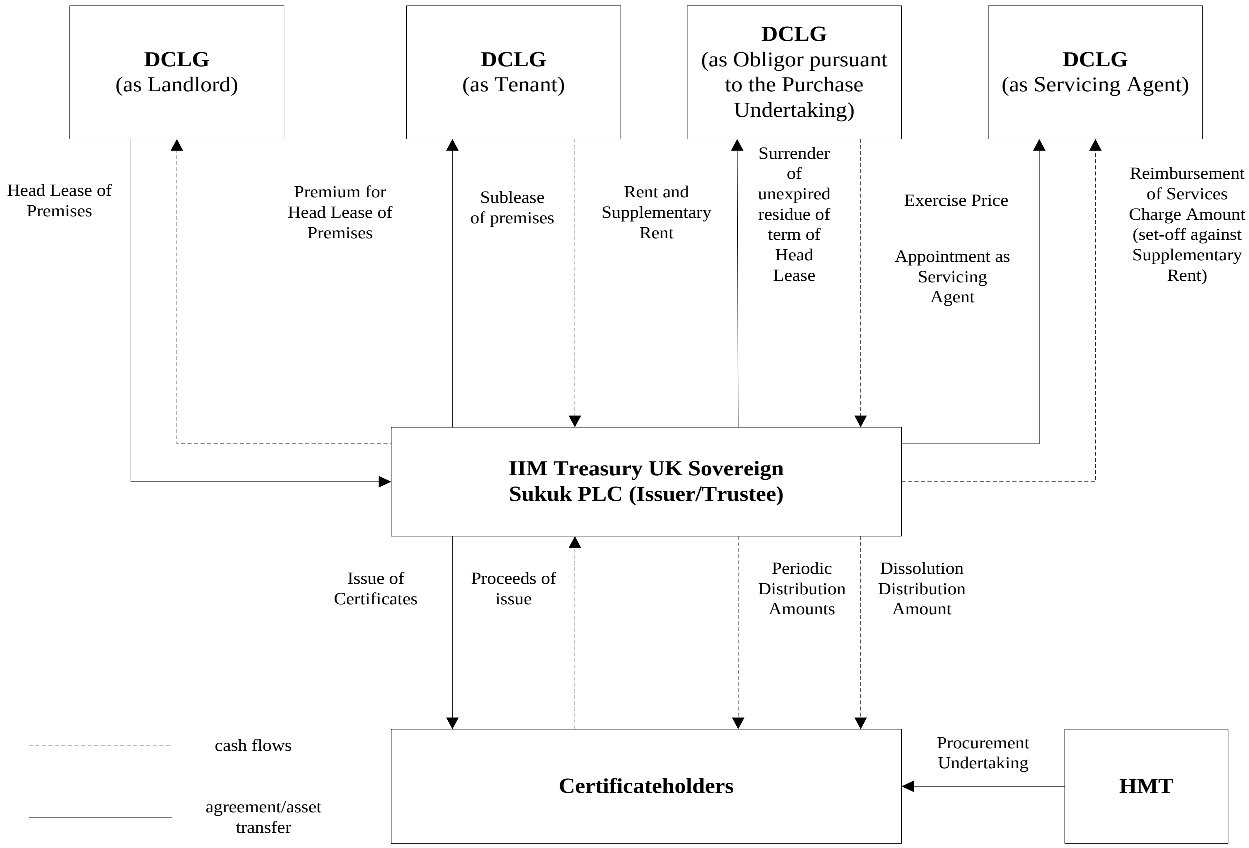
The UK has sought to position itself as an international hub for Islamic finance and this issuance embodies that commitment. Being the first of its kind by a European sovereign state, the transaction was truly ground-breaking and has laid the foundation for further Islamic financing in the UK. The transaction has set a precedent for entities wanting to draw on this largely untapped pool of *Shari'a* compliant investors. It opens up and provides a guideline for a whole new source of funding available to issuers within Europe.

The transaction documents were held to be *Shari'a* compliant by Bait Al-Mashura Finance Consultations Company, Shariah Committee of CIMB Islamic Bank Berhad, The Executive Shariah Committee of HSBC Saudi Arabia Limited and Standard Chartered Bank Shariah Supervisory Committee.

As a *Shari'a* compliant instrument, the issuance uses an *ijara* structure. The proceeds of this specific issue were used to acquire the lease of certain land and buildings from The Secretary of State for Communities and Local Government (**DCLG**). The properties were then sub-leased back to DCLG in return for DCLG making periodic rental payments. These rental payments are to be used by the issuer to fund its distributions to the sukuk holders.

SUMMARY OF TERMS & CONDITIONS	
Issuer	HM Treasury UK Sovereign Sukuk PLC
Issue Date	2 July 2014
Scheduled Dissolution Date	22 July 2019
Issue Price	£200,000,000
Face Amount	£100,000 and integral multiples of £1,000 in excess thereof
Rate	2.036%
Currency	Pounds Sterling (£)
Form	Global Certificate in Registered Form
Principal Paying Agent, Registrar and Transfer Agent	HSBC
Exchange	London Stock Exchange
Governing Law	English Law

The following diagram (simplified for the purposes of this article) illustrates the principal relationships between the parties and the cash flows of the structure.



First, the purchasers of the sukuk (Certificateholders) elect to pay the issue price to HM Treasury UK Sovereign Sukuk PLC (Issuer/Trustee). The Issuer/Trustee is a public limited company incorporated in the United Kingdom specifically to issue the sukuk and facilitate this transaction.

The Issuer/Trustee must then use the pooled capital to fund its acquisition of a 99 year lease over plots of land and buildings (Sukuk Asset) used for governmental purposes from DCLG.

After the purchase of the Sukuk Asset, the Issuer/Trustee has to hold the title to the asset on trust for the benefit of the Certificateholders. This ensures that the Certificateholders have an undivided beneficial ownership interest in the Sukuk Asset as declared by the Issuer/Trustee pursuant to a declaration of trust. This beneficial ownership of the Sukuk Asset along with certain other documentation provides the Certificateholders with a right to receive payments under it.

Next, the Issuer/Trustee shall sub-lease the properties back to DCLG. In consideration, DCLG is to make rentals payments to the Issuer/Trustee over the five year life of the sukuk. These rental payments are the source from which the Issuer/Trustee will pay the Certificateholders the periodic distributions owed to them. The Certificateholders will be owed these distributions as profits through their beneficial interest in the Sukuk Asset which is generating this income.

Finally, on the scheduled dissolution date, the Issuer/Trustee has the right to require DCLG to purchase back the unexpired term that remains on the lease. The Issuer/Trustee is to use this payment by DCLG to pay back the dissolution distribution to the Certificateholders. Again, the Certificateholders will be entitled to this payment as consideration for the sale of the Sukuk Asset, to which they will have an undivided beneficial ownership interest.

As this is the first sukuk issuance of its kind in the United Kingdom, it has a few notable features:

- The UK has been very active for the last few years in creating a level playing field between conventional instruments and their Islamic equivalents. A critical aspect to this is the tax legislation for the issuance of sukuk-al-ijara which is reflected in Schedule 61 of the Finance Act 2009. A large amount of time was spent manoeuvring through the framework and ensuring the structure and documentation complied with these requirements so that the transaction benefited from the various tax reliefs. In effect the sukuk was therefore treated the same as a UK Gilt for tax purposes.
- Whilst the primary obligor was the DCLG, and DCLG was the entity that was responsible for payment of the rent under the ijara agreement and the exercise price under the purchase undertaking, HM Treasury agreed, through the procurement undertaking, that it would either perform the obligations of DCLG or would ensure that DCLG was put in sufficient funds for DCLG to discharge its obligations in a timely manner.
- Unlike a usual sukuk issuance, this transaction utilises a Deed of Covenant. This allows the Certificateholders to have direct recourse and enforcement rights against the HMT should the Issuer/Trustee fail to make payments on maturity. A Deed of Covenant was included because HMT wanted to ensure that the sukuk holders were treated the same as its UK Gilt holders, who do have direct recourse to HMT.
- Some governmental real estate issues needed to be addressed and therefore intensive legal analysis was carried out on whether or not the government had a qualifying interest that complied with both *Shari'a* and the legislation. The governmental entity also had to have the capacity to deal with its assets in the manner envisaged by the transaction.

This transaction demonstrated Clifford Chance's breadth of knowledge and experience in Islamic Finance. Clifford Chance was able to provide a seamless service from multiple offices across several jurisdictions to ensure the success of this cutting-edge sukuk issuance. Having taken this defining step forward into previously undiscovered territory, Clifford Chance is in a prime position to aid with the further development of Islamic financing across Europe.

Clifford Chance's team, led by Qudeer Latif (Global Head of Islamic Finance) and supported by Debashis Dey, Chris Davies and Franc Pena advised HSBC Bank plc in its role as structuring bank and Barwa Bank, CIMB, HSBC Bank plc, National Bank of Abu Dhabi and Standard Chartered Bank as joint lead managers and Claudio Medeossi and Stuart Mason represented HSBC Bank plc as agent.

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