Abu Dhabi Islamic Bank leads the way with the world's first Basel III compliant Tier 1 Sukuk issuance

UAE & Mudarabah Deal of the Year

On the 19th November 2012, Abu Dhabi Islamic Bank (ADIB), one of the world's leading Islamic banks, successfully issued US$1 billion-worth of additional Tier 1 capital certificates, the world's first Basel III compliant Tier 1 Sukuk issuance. With an order book of US$15.5 billion (more than 30 times over-subscribed on the initial benchmark size) and with an expected profit rate of 6.375%, the lowest ever coupon for an instrument of this type, it is likely that the issuance will pave the way for other banks in the Middle East, both Islamic and conventional, to follow ADIB's lead. Latham & Watkins acted as counsel to ADIB on the issuance. NICK COLLINS, LEE IRVINE and ROBERTO LUIS REYES GASKIN explore the reasons behind the Sukuk issuance and what made it so successful.

Summary of terms & conditions	
Instrument	Sukuk Mudarabah
Issuer	ADIB Capital Invest
Principal Activities	Special Purpose Vehicle – Issuance of Regulatory Capital Instrument
Date of issue	19th November 2012
Issue size	US$1 billon
Tenor / Maturity	Perpetual
Term	Perpetual
Lead Managers	Abu Dhabi Islamic Bank, HSBC, Morgan Stanley, National Bank of Abu Dhabi and Standard Chartered
Co Managers	Barwa Bank and Sharjah Islamic Bank
Information Memorandum	Prospectus dated the 14th November 2012
Legal Counsel	The issuer and ADIB were represented by Latham & Watkins (English law and UAE law) and Maples & Calder (Cayman law). The lead managers and co-managers were represented by Linklaters (English law and UAE law)
Utilization of Proceeds	Invested in accordance with agreed investment plan pursuant to Mudarabah Agreement

Background

Against the backdrop of the global financial crisis, the Basel Committee on Banking Supervision promulgated a new regulatory framework for financial institutions, known as Basel III, which modified the existing regulatory framework of Basel II and has increased the quantity and quality of regulatory capital that financial institutions must retain. Under the Basel III regulatory framework, Tier 1 capital[1] must eventually equal at least 6% of the risk weighted assets of a financial institution once transitional phase-in periods elapse in 2019. Basel III does, however, allow 1.5% of this to be in the form of Additional Tier 1 capital, a layer of additional going-concern capital which, in addition to the bank's common equity Tier 1[2] capital, constitutes subordinated, paid-in capital capable of absorbing losses.

In order to qualify as Additional Tier 1 capital, an instrument must be subordinated to depositors, general creditors and subordinated debt, have no maturity date and may only be callable at the option of the issuer after a minimum of five years. The issuer must also have full discretion to cancel payments and the cancellation of such payments must not impose any restrictions on the issuer except in relation to distributions to the issuer's shareholders. In addition, subsequent to the initial release of Basel III, the Basel Committee on Banking Supervision indicated that Additional Tier 1 capital instruments must also incorporate either: (i) a write-down of the principal of the instrument; or (ii) a mandatory conversion of the instrument into common equity, if the financial institution's common equity Tier 1 falls below a certain threshold.

Whilst the implementation of Basel III is still in its preliminary phases, the central bank of the UAE has already begun rule-making in response to Basel III requirements with its first guidance circular released in July 2012. The UAE is not alone and the authorities in each of the current member states of the GCC have also started to prepare for implementation of Basel III or have signalled an intention to do so. In anticipation of the implementation of Basel III, both regional and international banks have therefore started to increase their Tier 1 capital ratios.

Tier 1 capital continues to be an important benchmark for investors when comparing financial institutions globally and for financial institutions looking to increase their Tier 1 capital ratio, Additional Tier 1 capital is attractive for a number of reasons. The discretion to cancel distributions, together with the requirement of principal write-down or mandatory conversion to common equity increase the resilience of a financial institution during challenging financial conditions.

Additional Tier 1 capital instruments also present a cost-effective means of accessing a wider investor base, including investors in Asia, the Middle East and Europe, without diluting shareholders. This helps preserve ownership structures in jurisdictions, such as the UAE, where governments, government-related entities and members of ruling families often hold, and wish to retain, substantial stakes in these financial institutions. The instruments are attractive to investors since they allow investors to diversify their risk portfolio and invest in companies with solid fundamentals at higher yields than they would receive from conventional debt instruments.

The Mudarabah

The structure of the transaction follows closely the structure of a typical Sukuk Mudarabah, with the incorporation of a special purpose vehicle, ADIB Capital Invest 1., to act as the issuer and Rab-al-maal.

On the issue date, the certificate-holders paid the issue price to the issuer. The issuer, in its capacity as trustee, declared a trust in favor of the certificate-holders over the proceeds of the issuance of the certificates, its rights, title, benefits and interests under the transaction documents and certain related rights. The issuer (as trustee) applied the proceeds of the issuance of the certificates towards the capital of the Mudarabah pursuant to the Mudarabah agreement. ADIB (as Mudareb) invested the Mudarabah capital into the business activities of ADIB in accordance with the agreed investment plan that is set out in the Mudarabah agreement.

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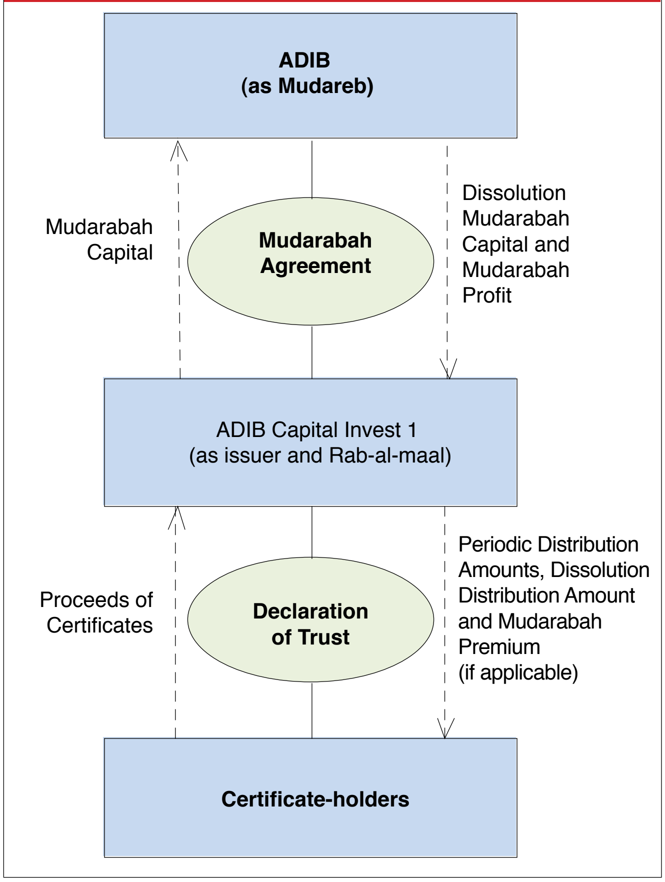
Unless a non-payment event[3] or a non-payment election[4] has occurred, on each periodic distribution date, ADIB (as Mudareb) will distribute the profit generated by the Mudarabah to both the issuer and Mudareb in accordance with an agreed split (90% to the issuer (as Rab-al-maal) and 10% to ADIB (as Mudareb)). The issuer then applies its share of the profit (if any) generated by the Mudarabah on each periodic distribution date to pay the periodic distribution amount due to certificate-holders on such date.

Unlike on previous Sukuk Mudarabah issuances, payments of Mudarabah profit by ADIB (as Mudareb) are at the sole discretion of ADIB and may only be made if ADIB meets certain conditions. ADIB (as Mudareb) has no obligation to make any subsequent payment in respect of any Mudarabah profit that is not paid in accordance with the Mudarabah agreement. To the extent that ADIB does not distribute profits under the Mudarabah, ADIB will not be able to declare or pay any distribution or dividend on ordinary shares issued by ADIB until two consecutive payments due under the Mudarabah have been paid in full (or equivalent amounts have been set aside for the benefit of the issuer (as trustee)).

The structure of the transaction



The certificates are perpetual securities in respect of which there is no fixed redemption date and accordingly, the Mudarabah is a perpetual arrangement with no fixed end date. Subject to certain conditions set out in the Mudarabah agreement, ADIB (as Mudareb) may at its option liquidate the Mudarabah in whole, but not in part, on the basis of an actual liquidation of the Mudarabah in the following circumstances:

(a) On the first call date or any periodic distribution date after the first call date[5]; or
(b) On any date on or after the issue date (whether or not a periodic distribution date):
   (i) Upon the occurrence of a tax event[6]; or
   (ii) Upon the occurrence of a capital event[7].

ADIB (as Mudareb) has agreed that it will only liquidate the Mudarabah to the extent that, on a dissolution, the Mudarabah capital would be equal to the nominal amount of the Sukuk to be repaid. To the extent that ADIB (as Mudareb) breaches this obligation, it is required to indemnify the issuer in respect of this shortfall.

Additional Tier 1 capital within an Islamic context – planning for success

While a number of conventional banks have issued Additional Tier 1 capital instruments, incorporating the required characteristics of Additional Tier 1 capital instruments into an Islamic context presented a number of additional challenges requiring close cooperation with the Shariah supervisory boards of ADIB and of the joint lead managers throughout the structuring and documentation phases of the deal. Significant time and effort was devoted to getting the structure right and in trying to 'keep it simple' (the latter was important to help chart a smoother course through the required Shariah, shareholder and regulatory approvals but also to structure the instrument in such a way as to maximize the appeal to local, regional and international investors). In addition, while the implementation of Basel III is still in its preliminary phases, both in the UAE and internationally, the instrument was structured in a way that anticipated the likely requirements of the UAE central bank to 'future-proof' the issuance so far as possible and to ensure the issuance would be in line with international best practice and expectations. Finally, the instrument had to be structured in a way that would be classified as (non-dilutive) 'equity' rather than 'indebtedness', that would allow ADIB to book the instrument as capital on its balance sheet, rather than as a liability. A Sukuk Mudarabah, a form of equity-based partnership arrangement whereby one partner provides capital (the Rab al-maal) and the other provides managerial skills (the Mudareb), which is generally seen under Shariah law as a profit-and-loss sharing partnership, provides an ideal Islamic structure to accommodate the features of Additional Tier 1 capital, such as the discretionary profit payments.

Conclusion

Since financial regulators throughout the GCC require relatively high levels of capital adequacy in order to protect depositors and borrowers, it is likely that Tier 1 capital issuances by UAE and other GCC banks, both conventional and Shariah compliant, will increase in 2013 in order to support the further growth that is expected in these countries.

As shown by the success of the ADIB transaction, an Additional Tier 1 capital instrument structured as a Sukuk Mudarabah can generate significant investor demand among both conventional and Islamic investors. This can provide banks with additional funding alternatives to bolster their capital structures amid a changing regulatory landscape and give investors the ability to participate in the dynamic GCC banking sector.

[1] According to the Basel Committee on Banking Supervision, Tier 1 Capital represents the layer of highest-quality going-concern capital, defined as the sum of the following: Common Equity Tier 1 and Additional Tier 1 instruments.

[2] Common Equity Tier 1 capital under Basel III is comprised of the following: the bank's common shares, stock surpluses, retained earnings, certain other reserves and common shares issued by consolidated subsidiaries of the bank held by third parties.

[3] A non-payment event would occur if: (i) the payments required to be made by ADIB under the Mudarabah agreement, when aggregated with any other obligations ranking senior to, or pari passu therewith, exceeds ADIB's non-consolidated retained earnings and reserves; (ii) on the date of payment, ADIB is in breach of its applicable regulatory capital requirements or the making of such payment would cause it to be in breach thereof; (iii) the financial regulator requires ADIB not to make the relevant payment; or (iv) on the relevant date of payment ADIB is not solvent, or would not be solvent if the relevant amount was paid.

[4] A non-payment election would occur if ADIB, in its sole discretion, elects not to pay the Mudarabah profit.

[5] As a regulatory requirement, the first call date must be at least five years from the issue date.

[6] A tax event would occur if there was a change in the tax laws which resulted in additional amounts becoming payable under the Mudarabah agreement and/or the certificates.

[7] A capital event would be deemed to have occurred if ADIB is notified in writing by the financial regulator that the notional amount of the certificates would cease to qualify as Tier 1 Capital.

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