

GUIDANCE NOTE ON ISSUANCE OF AVIATION SUKUK IN LABUAN INTERNATIONAL BUSINESS AND FINANCIAL CENTRE

1.0 Introduction

- 1.1 The Guidance Note on Issuance of Aviation Sukuk¹ in Labuan International Business and Financial Centre (IBFC) is issued to enhance market awareness and provide market guidance on the diverse aviation sukuk that can be structured under a variety of Shariah principles in Labuan IBFC.
- 1.2 This guidance note is to be read together with the Explanatory Note on Issuance and Subscription of Sukuk in Labuan IBFC.

2.0 Background

- 2.1 Islamic finance is increasing in significance as a source of finance for the aviation industry. Many of the world's leading airlines have made a foray into the Islamic finance market to issue aviation sukuk to raise funds for the purpose of funding the acquisition or leasing of new aircraft.
- 2.2 Aviation sukuk allows issuers access to new sources of funding from the largely untapped Islamic investors in different regions and markets. Aviation sukuk also offers Islamic investors a new asset class for better diversification of their investment portfolios.
- 2.3 Labuan IBFC is an ideal jurisdiction for aviation sukuk issuance particularly for the Asia-Pacific region as it has a comprehensive infrastructure that supports and accords certainty as well as integrity for Shariah-based structures. In addition, Labuan IBFC is home to a profusion of aviation leasing companies that can leverage on the Centre for aviation sukuk issuance to finance their aviation business needs.

¹ Aviation Sukuk in the guidance note refers to sukuk issued for aviation financing.

3.0 Labuan IBFC's Facilitative Regime for Sukuk Issuance

3.1 Labuan IBFC has in place a conducive ecosystem for sukuk issuance and investments. Labuan IBFC's facilitative regime for sukuk issuance and investments is reflected by its market features as follows:

3.1.1 Well-developed Islamic Finance Infrastructure

- (i) The Centre has an integrated and internationally recognised legal, regulatory and Shariah framework that confer certainty and uphold the integrity of Islamic financial transactions.
- (ii) The broad and liquid Islamic capital market offers a wide range of Islamic financial instruments as well as diversified and skilled financial service providers.
- (iii) There is a significant pool of talent in structuring new innovative Islamic financial instruments.
- (iv) A wide investor base is available from Islamic and conventional financial institutions, pension funds and fund management companies.
- (v) Issuers have an opportunity for listing on any of the international exchanges including the Labuan International Financial Exchange (LFX).

3.1.2 Supportive Islamic Finance Ecosystem

- (i) The Centre has no foreign exchange restrictions.
- (ii) There is mutual recognition of Shariah opinions issued in other jurisdictions.
- (iii) The Centre allows flexibility in applying the preferred governing law in the offering documents.

3.1.3 Strategic Jurisdiction

- (i) Labuan IBFC provides a gateway to Asia Pacific markets and its promising growth prospects and economic opportunities, making it strategically positioned for attracting investors for sukuk issuance.
- (ii) Issuers can benefit from competitive pricing, which may be better as compared to conventional bond pricing due to the high demand of sukuk in the region.

3.2 More specifically for aviation sukuk issuance, Labuan IBFC also serves as an attractive domicile for aviation leasing companies based on the favourable ecosystem exemplified by the following attributes:

- (i) Large readily available aviation-related talent pool.
- (ii) Common law legal system that is familiar to most lessors.
- (iii) More cost-efficient way of doing business compared to most other aviation hubs in Asia.
- (iv) Availability of sufficient capital via domestic and international financial institutions.
- (v) An aviation leasing market with a close geographical proximity to the Asia-Pacific aviation industry.
- (vi) Extensive network of tax treaties, spanning more than 80 countries.
- (vii) Substance-enabling market that complies with all international tax and regulatory standards of Organisation for Economic Co-operation and Development (OECD).
- (viii) Robust and supportive legal framework including for aviation leasing and Shariah-based leasing solutions (Ijarah structures).
- (ix) Competitive fiscal regime and business-friendly regulatory environment.
- (x) Responsive anti-money laundering and counter-terrorist financing regulations.

4.0 Labuan IBFC's Regulatory Requirements for Sukuk Issuance

4.1 Labuan IBFC's regulatory requirements for sukuk issuance are delineated below:

4.1.1 Legal Provision

The issuance of sukuk in Labuan IBFC is subject to the provisions of Part III of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA).

4.1.2 Eligible Issuers

Any person², through the establishment of a Labuan company or registration of a foreign Labuan company under the Labuan Companies Act 1990, may make an offer or invitation to subscribe for sukuk in or from Labuan IBFC.

4.1.3 Approval Requirements

- (i) Any person who makes an offer for subscription or purchase or issues an invitation to subscribe for or purchase sukuk (subsequently referred to as offer for subscription of sukuk) in or from Labuan IBFC, must obtain prior written approval from Labuan FSA under Section 13(1) of the LIFSSA, unless the offers or invitations of sukuk are excluded from the approval requirements of Labuan FSA as specified under Section 13(5) of the LIFSSA.
- (ii) The offers or invitations of sukuk which are excluded from the requirement for prior written approval of Labuan FSA³ includes an offer or invitation of sukuk where the first time investment of each of the initial sukuk holders is:
 - (a) not less than two hundred and fifty thousand ringgit (or the equivalent in any other currency); or
 - (b) less than two hundred and fifty thousand ringgit (or the equivalent in any other currency) with the invitation to whom the offer is communicated does not exceed fifty person;and the investors are in possession of sufficient information to be able to make a reasonable evaluation of the offer or invitation.
- (iii) A resident of Malaysia who makes an offer for subscription of sukuk in or from Labuan IBFC, is subject to the requirements of the Capital Markets and

² "Person" includes a corporation, partnership, a body of persons, corporate or unincorporated and a corporation sole.

³ For the issuance of sukuk that falls under Section 13(5) of LIFSSA, Labuan trust companies as the resident secretary of the Labuan company shall notify Labuan FSA not later than 30 calendar days after the issuance of the sukuk in Labuan IBFC.

Services Act 2007 together with its relevant amendments and the Foreign Exchange Administration Rules issued by Bank Negara Malaysia⁴.

- (iv) A non-resident who makes an offer for subscription of sukuk in or from Labuan IBFC is required to register the disclosure document with the Securities Commission Malaysia as specified in the Capital Markets and Services (Amendment of Schedule 5, 6, 7, and 8) Order 2015.

4.1.4 Eligible Investors

- (i) Any person may subscribe to the sukuk issued in or from Labuan IBFC.
- (ii) Residents of Malaysia may subscribe to the sukuk issued in or from Labuan IBFC, subject to the requirements under the Foreign Exchange Administration Rules issued by Bank Negara Malaysia⁵.

4.1.5 Shariah Endorsement

The sukuk structure shall be endorsed by a Shariah adviser to ensure compliance with Shariah principles.

5.0 Aviation Sukuk Structure based on Ijarah (Lease)

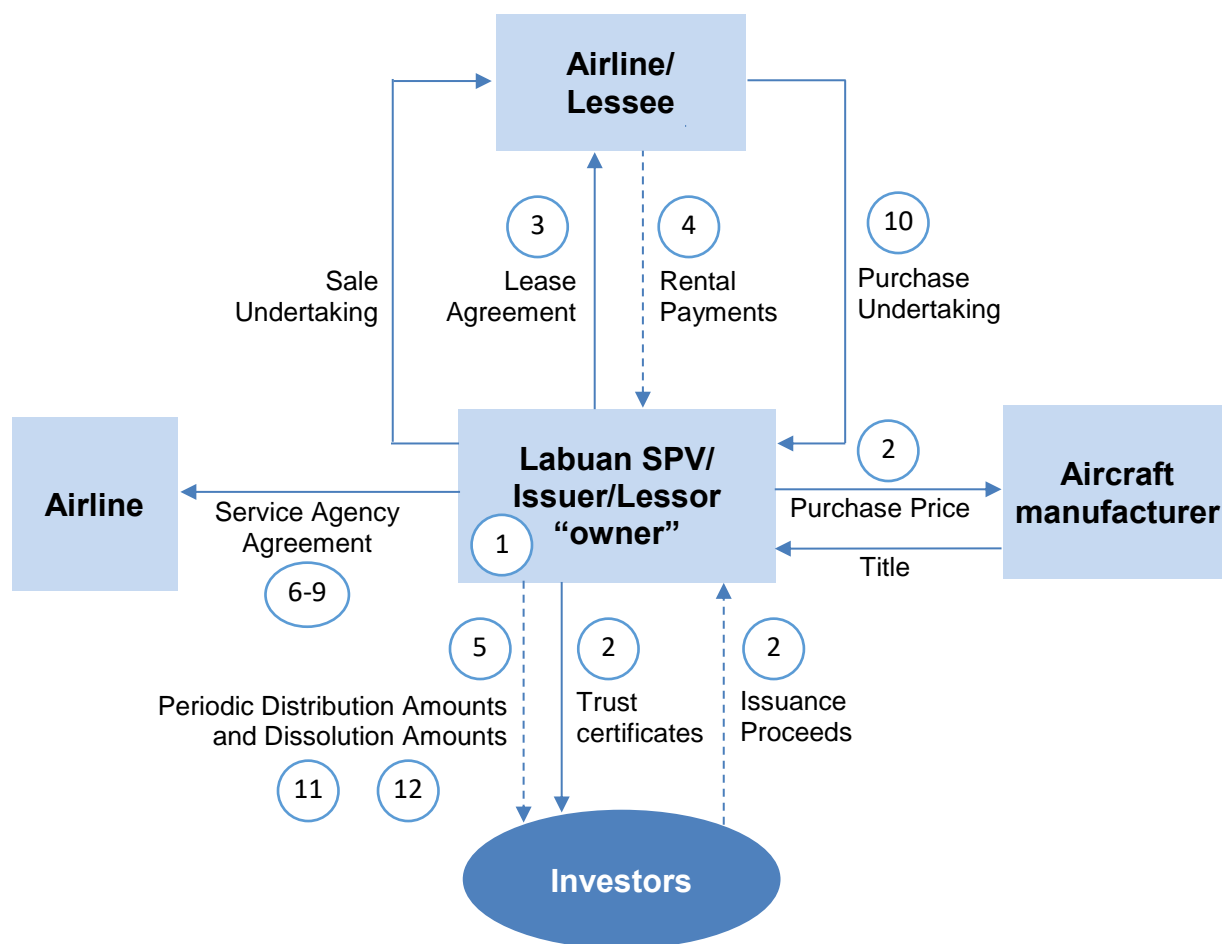
5.1 Aviation Sukuk can be structured based on various underlying Shariah contracts. Notwithstanding this, Ijarah⁶ Sukuk is one of the most widely used structures for financing aircraft acquisitions as most airline companies rely on leasing arrangements to finance their acquisition of new aircrafts.

5.2 An Aviation Sukuk issued based on Ijarah structure is illustrated in the diagram below:

⁴ Please refer to Notice 2 – Borrowing and Guarantee under Bank Negara Malaysia’s Foreign Exchange Administration Rules.

⁵ Please refer to Notice 3 – Investment in Foreign Currency Asset under Bank Negara Malaysia’s Foreign Exchange Administration Rules.

⁶ Ijarah is a lease contract where the lessor/owner transfers the ownership of usufruct to the lessee in return for compensation to the lessor.



1. The airline company that wishes to purchase an aircraft and plans to raise finance through the issuance of sukuk identifies the seller or manufacturer of the aircraft. Negotiations are entered into and finalised between the seller and airline company. The airline company creates a special purpose vehicle (SPV) to issue the sukuk.
2. The SPV issues sukuk certificates and receives the proceeds which are used to purchase the new aircraft from the aircraft seller or manufacturer.
3. The SPV holds the aircraft as trustee for investors and leases the aircraft to the airline company under Ijarah agreement.
4. In accordance with Ijarah agreement between the airline company and the SPV, the airline company pays rentals to the SPV for tenure and amounts matching the sukuk coupon's amount and tenure.

5. The SPV then pays investors the periodic coupon distribution amounts.
6. The SPV enters into a service agency agreement with the airline company and appoints the airline company as service agent for the leased aircraft.
7. The SPV as the lessor, is responsible for maintenance which involves the fundamental structure of the leased aircraft. Meanwhile, the airline company as the lessee, is responsible for the operational maintenance such as the maintenance to ensure the sustainability of the leased aircraft.

Notwithstanding this, the maintenance of the leased aircraft may also be determined as agreed by both parties as stated in the terms and conditions of the Ijarah agreement. Any maintenance in relation to the fundamental structure of the leased aircraft which is basically the responsibility of the lessor may be assigned to the lessee as service agent at the lessor's cost.

8. The leased aircraft shall be insured by takaful coverage. However, if the takaful coverage is not available (or is not commercially viable), the leased aircraft may be covered by conventional insurance. The SPV as the lessor (owner) shall be liable for the costs of maintaining takaful or conventional insurance coverage over the leased aircraft.

The lessor (owner) may appoint the lessee to obtain takaful or conventional insurance coverage and the lessee may claim for reimbursement for the costs incurred.

9. In the event of a total loss of the leased aircraft, the following actions may be taken:
 - (i) The lessee shall be entitled to terminate the Ijarah contract; or
 - (ii) The lessor (owner) of the leased aircraft shall replace the affected leased aircraft with other suitable Ijarah assets as mutually agreed by the lessor and lessee.
10. The airline company may grant irrevocable purchase undertaking to buy the aircraft on the maturity of the sukuk.
11. Upon maturity, the SPV redeems the trust certificate for investors upon the dissolution of the SPV.

12. The SPV receives the purchase price from the airline company at dissolution. Upon payment to the sukuk holders, the aircraft is transferred to the airline company.

6.0 Aviation Sukuk Structure based on different Shariah contracts

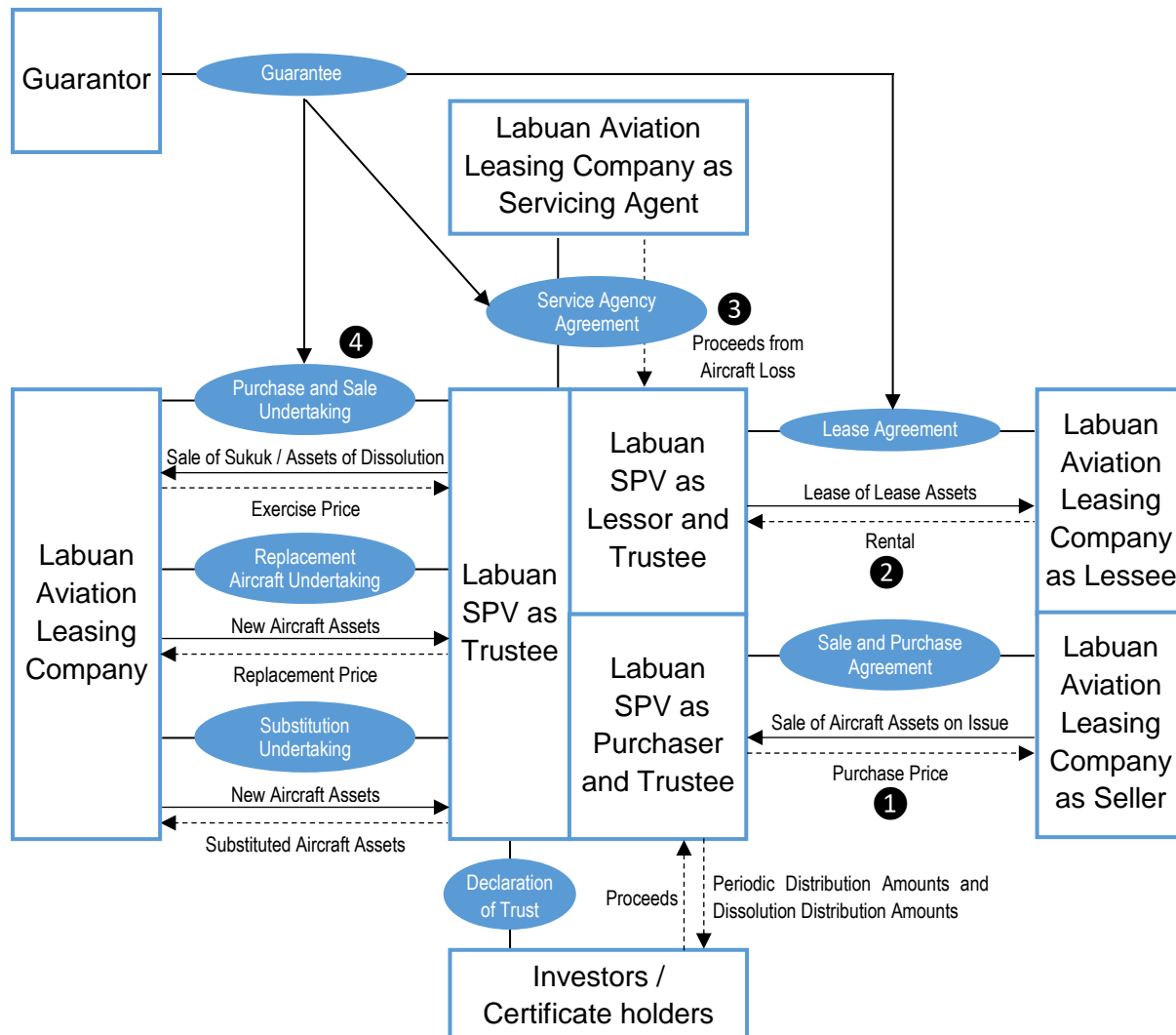
- 6.1 Aviation sukuk can be structured based on different Shariah contracts which are suitable for the proposed financing and approved by the Shariah adviser. The Appendix of the Guidance Note highlights some of the structures of aviation sukuk as reference.

Labuan Financial Services Authority

15 May 2020

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AVIATION SUKUK : IJARAH (SALE AND LEASE BACK) STRUCTURE



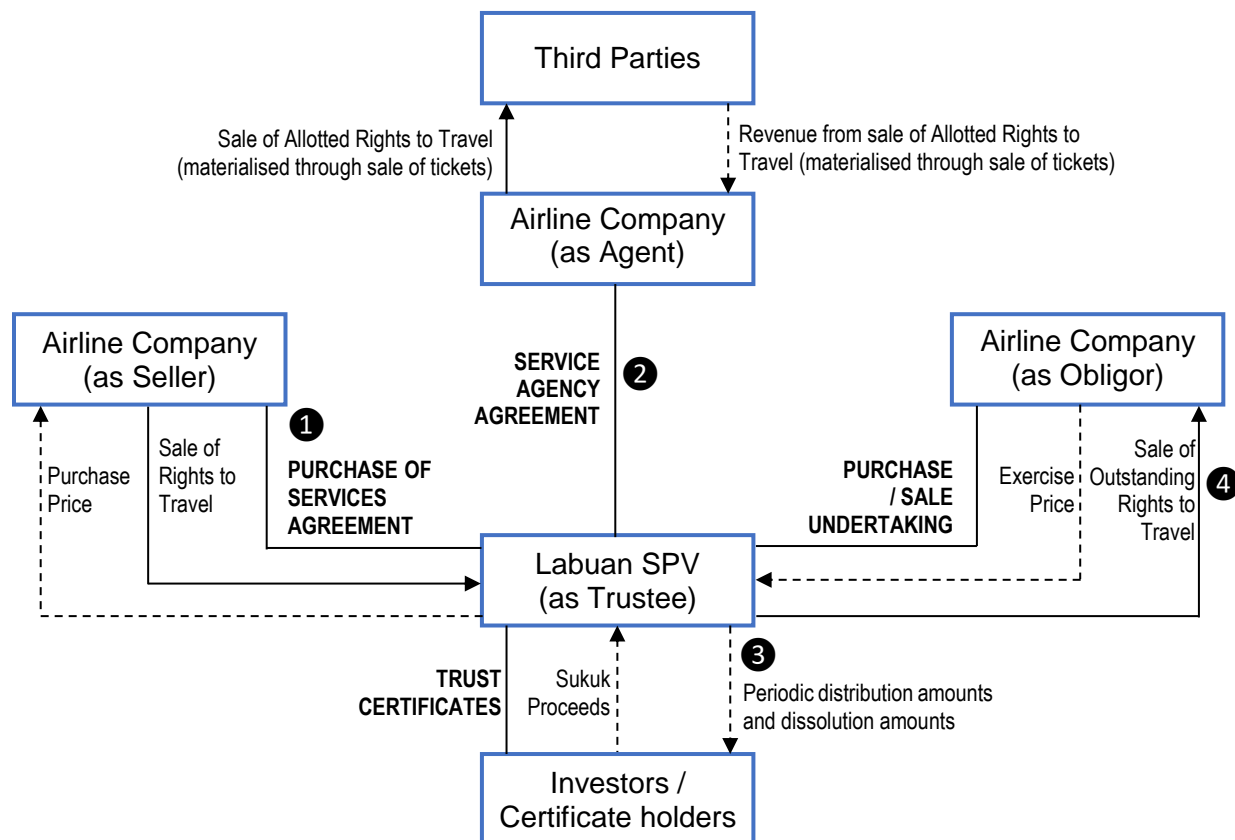
Legend:

- > - Cashflows (or non-cash debits and/or credits, as applicable)
- > - Sale
- - Contract or Agreement

Structure Description

1. Labuan Aviation Leasing Company (LALC) enters into a Sales and Purchase Agreement with the Trustee (Labuan SPV) to sell Aircraft Assets. The purchase price paid by the Trustee will be an amount equal to the net proceeds received by the Trustee in connection to the issuance of certificates to the investors.
2. The Trustee will lease the Aircraft Assets (Lease Assets) to LALC (Lessee). The Lessee will pay the lease rental payments to the certificate holders in such amounts as are at least equal to the Periodic Distribution Amounts due under the Certificates on each Periodic Distribution Date.
3. The Trustee will enter into a Service Agency Agreement with LALC and will appoint LALC as its servicing agent for the Lease Assets.
4. Pursuant to an Asset Purchase Undertaking upon maturity or dissolution event, the Trustee may require LALC to purchase the Lease Assets owned by the Trustee at the exercise price. The Trustee then pays the certificate holders for the redemption of the sukuk.

AVIATION SUKUK : WAKALA STRUCTURE



Legend:

- ▶ - Cashflows (or non-cash debits and/or credits, as applicable)
- ▶ - Sale
- - Contract or Agreement

Structure Description

1. The Trustee (Labuan SPV) enters into a Purchase of Services Agreement with the Airline Company (the Seller), pursuant to which the Trustee will use the proceeds of the issue of the Certificates as the purchase price for Rights to Travel.
2. The Trustee (as principal) and the Airline Company (as Service Agent) enter into a Service Agency Agreement for the sale of allotted rights to travel materialized through the sale of tickets.
3. On each periodic distribution date, the Service Agent will pay the Trustee the periodic distribution amounts and partial dissolution amounts payable by the Trustee to the certificate holders.
4. In the event of dissolution, the Trustee will have the right to require the Airline Company to purchase the unsold Allotted Rights to Travel for the payment of the outstanding principal amount of the Certificates plus all due but unpaid periodic distribution amounts. The Trustee then pays the certificate holders for the redemption of the sukuk.