

Significance of Sukuk Securitization For Banks Structuring for Risk Regulation and Pricing

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ABSTRACT

This paper discusses the mechanism of Sukuk securitization in comparison with conventional asset securitization. Sukuk are popularly being used as a funding mechanism by the governments and corporations throughout the Muslim world and other countries. Involvement of multinational western banks as well as local Islamic and conventional financial institutions as arrangers, underwriters and managers of the sukuk issues is seen. Sharia'h requirements for sukuk as Islamic financial transactions (may) limit some of the aspects of conventional asset backed securitization. The author discusses current sukuk structures and delves on the popular sukuk structures if used as an alternate source of funding by Islamic (as well as conventional) banks. Due to the inherent nature of banks as financial intermediaries and their responsibility towards depositors, the paper focuses on the extent of risk mitigation through the sukuk model involving Special Purpose Vehicles (SPV's) and subsidiaries. The implications in operational risk mitigation and pricing are analysed for such asset-backed transactions by banks, keeping in view the Sharia'h injunctions as well as the regulatory regimes involved.

Introduction

This paper discusses a currently popular product namely Sukuk (singular sak) in the domain of Islamic finance. The popular structural dynamics of sukuk are explained with a view to discuss how and why the product can be used by Islamic financial institutions. Attributes of the product necessitates the view on its risk perspective and regulatory implications. In addition, the essential use of special entities in the process of product arrangement are also analyzed.

Any financial cum-business activity undertaken on the basis of the Islamic principles falls under the domain and discussion of Islamic finance. The Islamic teachings through the Holy Quran and Sunnah, prohibits riba¹ particularly while permitting profit-making through trade². It does not allow speculation and gambling, which are termed as haraam or impermissible in Islam. Trade and business of impermissible items and activities³ is also prohibited. Islamic Finance as a discipline is considered to encompass the banking as well as securities sector, and the area of activity is inclusive of the money market as well as the capital markets, the bonds as well as the stock markets.

The conventional banking sector is the primary user of riba as a tool for the “credit and money creation”. While the deductions⁴ from Islamic principles of business and finance calls for collective risk and reward sharing, between the provider of funds and user of funds, the conventional systems⁵ separates the funds provider and funds user and separates their risks and returns. The funds providers and funds users (“shop” or) search for getting a better deal for their requirement on the basis of the return and cost of funds respectively. Depending on their particular needs, pros and cons, they can avail the banking sector or the securities/bonds market or go public by availing the stock market. On the basis of pure (economic) market dynamics, money flows to the avenues where a better rate (return) is available.

The securities /bond market is another important source of generating funds. Securities of various types and maturities are floated directly in the market through private placements, investment agents and institutions. Buyers of the securities can be institutional purchasers or high net worth individuals whose purpose of investing suits the offer of the issuers of these scrips. Bonds of various maturities and valuations are floated in the market from time to time. The securities issued are accompanied by mainly by the memoranda and other offering document to the investors. These legal –cum regulatory documents describe the conditions and modalities of the security/ies offered. Some bonds carry a fixed rate of interest while others have a floating rate, usually issued with respect to (as certain basis points above, below, equal to) a floating rate like London Interbank Offer Rate (LIBOR) for foreign currency denominated bond or the Karachi Interbank Offer Rate KIBOR for a local currency bond in Pakistan.

¹ Primarily meaning taking /earning excess money on money lent.

² Refer to Annex 1, for excerpts on riba.

³ They include trade and business dealing with alcohol, pork, drugs (like cocaine etc.), gambling, etc. and their forms.

⁴ This deduction is based on the author’s study, analysis and interpretation of the available literature regarding the principles of Islamic banking and finance, some of which are referenced in the current paper.

⁵ Whether in banking (lender-borrower relationship), or securities and bonds (bond-holder versus bond issuer).

The products under discussion is suk (singular) or sukuk (plural and as a tranche of investments). Sukuk (singular sak) as financial products are financial scrips representing proportionate ownership to tangible assets. Investment Sukuk are defined as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.”⁶ Sukuk are issued to represent ownership in assets or usage rights of assets (as in Ijara’h, (leasing)). Like stocks (shares) of a company, they represent ownership entitlement of assets and the returns on the sukuk ought to be based upon the returns from those underlying assets. However, without tangible assets or rights of usage of the assets, there can be no sukuk. Unlike stocks (shares) Sukuk in practice, usually do have a maturity period, and this property brings them closer to bonds. Hence we can define sukuk as “equity bonds”, while defeating and negating the primary definition of bonds being debt- based instruments. These represent a source of generating funds that is islamically permissible and derives (should derive) its returns from the underlying assets they represent. There are different types of investment sukuk such as Ijarah sukuk, Musharika certificates and others⁷ . The current size of the sukuk market is estimated as 40 Billion⁸ by the end of 2006.

Description of Sukuk

As mentioned earlier, Sukuk can be termed as “equity bonds”. They ought to be representatives of equity⁹ while their modus operandi in floatation is that of the bonds as above. They are accompanied by an offering prospectus and their rate of return is usually related to the LIBOR¹⁰ or KIBOR benchmarks. The two contrasts of equity and bonds are fused together through an intricate mechanism which is also described in the prospectus in wordy legal terminology.

So far the predominant majority of sukuk on the international scene are issued by sovereigns, autonomous public bodies, conglomerates and corporations. The Bahrain Monetary Authority and the Liquidity Management Centers have started issuing mostly short term sukuk mainly for the purpose of deepening the sukuk market and improve liquidity of the sukuk market. However, we shall not discuss the liquidity of the sukuk market in the current paper. The point being made is **that the banking sector (financial institutions) comprising stand alone financial institutions including the multinational financial institutions have not participated as issuers of sukuk , barring one or two very recent examples** of sukuk being issued by financial institutions as part of a group of companies.

⁶ “*Shari’a Standards*”,1424-5H/2003-4 , Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Shari’a Standard No. 17, Investment Sukuk, pg298.

⁷ as defined by the Sharia’ Standard No. 17, Investment Sukuk pg 298-300,“*Shari’a Standards*”,1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) ,

⁸ According to Moody's Investors Service

⁹ to be islamically permissible, they ought to represent underlying real assets or the usage rights of underlying assets (as in Ijara’h)

¹⁰ London Interbank Offer Rate (LIBOR), and Karachi Interbank offer Rate (KIBOR)

Popular sukuk structures in practice

The sukuk structures in practice are of a number of types¹¹. However, in the current surge of the international issues of sukuk, Ijarah sukuk is the most commonly used type. Some others have composite sukuk with a requirement of predominance of Ijara'h transactions¹². Another sukuk structure which is based on musharika and Mudarabah structures or their combination causing joint ventures. There is capital participation and sharing of risk as well as rewards of the participating entities including the sukuk holders, in the venture or project. In sukuk based on Mudarabah, one party provides capital while another services.

In principle, sukuk can be based either on fixed profit sharing basis (as in Ijara'h sukuk) and variable profit and loss sharing basis (as in the Musharika and Mudarabah sukuk types). In practice , perhaps the fixed returns and literally no risk of loss enabled through the Ijara'h sukuk make them the popular choice of investors. Therefore, most of the sukuk are based on the Ijara'h principle. Hence we shall delve on the Ijara'h sukuk in more detail.

Ijara'h sukuk:

The reasons for popularity of Ijara'h sukuk can be many. For example, its suitability within the current, predominant, conventional of the business-cum finance set-up and mind set of the investors or the structure being close to the existing system.

Ijara'h sukuk represent certificates of ownership in leased assets. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines it as¹³, "... certificates of equal value issued by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the assets and recovering its value through subscription so that the holders of the certificates becomes owners of the assets."

Similarly certificates of ownership of usufruct of existing assets can be issued either by the owner of an existing assets "with the aim of leasing the asset and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the certificates. In another type of Ijara'h sukuk, certificates of equal value can be issued by the lessee i.e., the owner of usufruct of an existing asset, "either on his own or through a financial intermediary, with the aim of subleasing the usufruct and receiving the rental from the revenue of the subscription, so that the holders of certificates becomes the owners of the usufruct of the asset."¹⁴ Yet another type of Ijara'h sukuk certificates representing certificates of

¹¹ Ijarah (leased assets) , Salam , Istisna' , Murabaha, Musharika, Muzara'a (sharecropping) , MUSAQA (irrigation) and Mugharasa (agricultural) Sukuk are types of Investment sukuk defined in , Sharia' Standard, no. 17 , of the Accounting and Auditing Organization for Islamic Financial Institutions(AAOIFI) Bahrain ,dated 1424-5H/2003-4.

¹² For example, the US \$ 400mn. composite sukuk (Trust certificates), by the Solidarity Trust Services Limited floated on August 12, 2003, with the Islamic Development Bank (IDB) as originator, and the underlying assets comprising a portfolio of the Ijara'h , Murabaha and Istisna'a transactions effected by the IDB.

¹³ according to the AAOIFI Shari'a Standard No. 17, on Investment Sukuk,

¹⁴ (AAOIFI), Shari'a Standard No. 17, Investment Sukuk, pg298

ownership of usufruct of described future assets (para 3/2/2) can be issued “for the purpose of leasing out tangible future assets and for collecting the rental from the subscription revenue so that the usufruct of the described future asset passes into the ownership of the holders of the certificates. Besides, there are also certificates of ownership of services of a specified party.

Examples of Ijarah Sukuk Certificates

*Take for example one of the pioneering international sukuk of US \$ 600 million ,issued on 03 July 2002 due 03 July 2007, namely the **Malaysian Global Sukuk**, listed initially on Luxembourg Stock Exchange and Labuan International Financial Exchange Inc. and later at Bahrain BMA (debt market) too. It was rated “Baa2” by Moody’s Investors Service Inc. and “BBB” by Standard & Poor’s. It was an Ijara’h sukuk structure and from the debt market perspective they are categorized as Regulation S Global Certificates. Its assets primarily consists of beneficial title to certain land parcels and rights under the related lease agreements. It was priced at Libor+0.95%p.a (For Regulatory requirement see footnote ¹⁵)*

The Ijarah arrangement was structured as follows: The underlying assets comprised properties purchased from the country’s Federal Land Commissioner for a five year term and the properties held in trust via a Special Purpose Vehicle (SPV). The SPV namely The Malaysia Global Sukuk Inc.¹⁶, leased the properties to the government, which issued floating rate trust certificates (sukuk) to investors. The sukuk pricing was referenced against sovereign’s credit curve rather than the value of the property assets.¹⁷

***Qatar Global Sukuk (QGS)** floated US \$ 700 Million worth sukuk in 2003, due 2010. These are Global sukuk issued with the structure of Ijarah sukuk. Under this arrangement, QGS purchased a certain land parcel from the government of the State of Qatar. This land parcel was leased by QGS to the State of Qatar for a seven-year period corresponding to the duration of the trust certificates¹⁸. QGS holds these assets in trust for the holders of the trust certificates. The lease rental payments from the government of the State of Qatar to QGS will exactly match the periodic distribution payments payable on the trust certificates. The lease rental payments are calculated based on six-month U.S. dollar LIBOR plus a margin of 0.40 percent. The issue was assigned an A+ rating in the category of foreign currency senior unsecured debt. According to the transaction structure QGS issued rated trust certificates (Sukuk), and its proceeds are*

¹⁵ Offered to Institutional investors, following Rule 144A of Securities Act in USA. and under Regulation S outside the US. The offer and sale of Certificates to it is being made in reliance on the exemption from the registration requirements of the Securities Act provided by Rule 144A or Regulation S.

global registered certificates kept with common depository (the “Common Depository”*) for Euroclear Bank S.A/N.V. as operator of the Euroclear System (“Euroclear”) and Clearstream Banking, société anonyme (“Clearstream, Luxembourg”). Certificates offered and sold in the United States to Qualified Institutional Buyers (QIBs) in reliance on Rule 144A (the “Rule 144A Certificates”). (*Common Depository for Euroclear and Clearstream, Luxembourg.), records maintained by Euroclear and Clearstream, Luxembourg,; transfers thereof will be effected only through, records maintained by Euroclear and Clearstream, Luxembourg and will be subject to certain restrictions on transfer.

¹⁶ was incorporated in Labuan, Malaysia under the Offshore Companies Act, 1990 of Malaysia on 3 June 2002

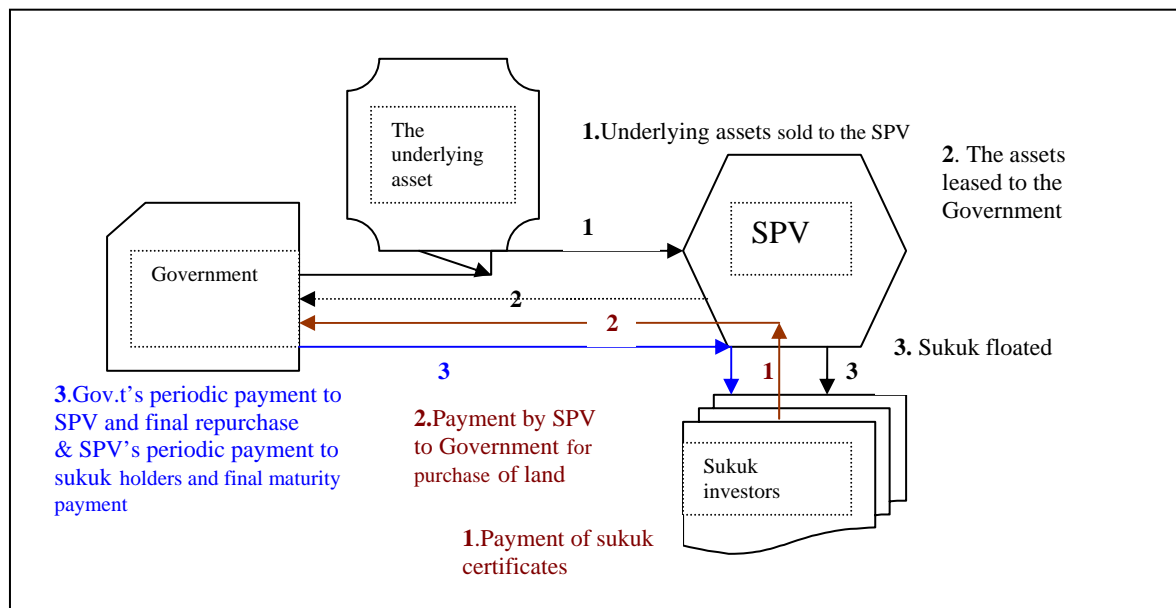
¹⁷ Lease rentals from government to the SPV exactly matches the payments payable on the trust certificates. At expiry of the purchase agreement (for the assets) the government will buy back the properties at the face value of the bond . i.e. any rise or fall in the valuation of the underlying assets will not affect the bond issue.

¹⁸ The land parcel excluded any/all buildings and all other fixtures that were/are a part of it, at any time, in respect of which the acquisition, construction, or completion costs are paid for by the government.

ultimately used by the government of the State of Qatar¹⁹. The lease rental payments are irrevocable²⁰.

Similarly another example of the US\$600mn, Trust Certificates (Sukuk) by the **Pakistan International Sukuk Company**, (PISC) and listed on Luxembourg Stock Exchange. These were structured as Ijarah Sukuk similar to the above two structures) and qualify under the Regulation S of the bond market specification. They were issued on January 27 2005 due January 27, 2010. PISC (the issuer) is a public limited liability company, incorporated²¹ in Pakistan. The sukuk were priced at 6 month Libor + 220 bps and were rated as B+ by Standard and Poor's (S&P) rating agency.²². The certificates were issued for financing the construction of Motorway in the country. The Trust Assets consisted of the existing Highway Land (M 2 Motorway) as underlying assets. The trust assets were leased out to the lessee, (The President of Pakistan) on behalf of the Government of Pakistan²³.

The structure of these Ijarah sukuk are given in Figure 1, as a simplified basic structure.



19 All claims due to QGS, including the lease rentals payable by the government of the State of Qatar to QGS under the master 'Ijara'h agreement, which fund the periodic distribution payments on the trust certificates, are a direct, unconditional, unsecured, and general obligation of the government of the State of Qatar and will rank at least pari passu with all other unsecured and unsubordinated

20 Qatar Global Sukuk , offering prospectus/Memorandum, 2003

21 Companies Ordinance 1984, Ordinance No. XLVII of 1984

22 The Certificates were issued in registered global form , deposited with a common depository for Euroclear and Clearstream , Luxembourg

23 The Government of Pakistan is obliged to make payments under the Transaction Documents to which it is a party to the issuer, and the trustee, for the benefit of the certificate holders, will have direct recourse against the Government to recover payments due from the government pursuant to such documents.

Securitization and financial institutions:

Upon deciphering the sukuk mechanism, in many **instances, it closely resembles the asset securitization** structures. Through asset securitization, generally the illiquid assets of a company or a financial institution are transformed into a security. The security (e.g. bonds, commercial papers) is issued to prospective investors. It can be traded in a capital market. Asset securitization mechanism is popularly utilized by specialized financial institutions like Mortgage Houses and other financial institutions to divest their loan portfolios and reshape their balance sheets. However, the term asset-backed security (ABS) is generally applied to security issues backed by non-mortgage assets. It seems that nowadays, almost any income-producing asset with an adequate track record and some backing or mechanism of diversification and tranching of credit risk, can be securitized through the conventional finance procedures. (were principal and interest flows are taken into consideration. Examples include consumer finance receivables like auto (car) loans, student loans and credit card receivables. These are a very important category of the non-mortgage ABS market.

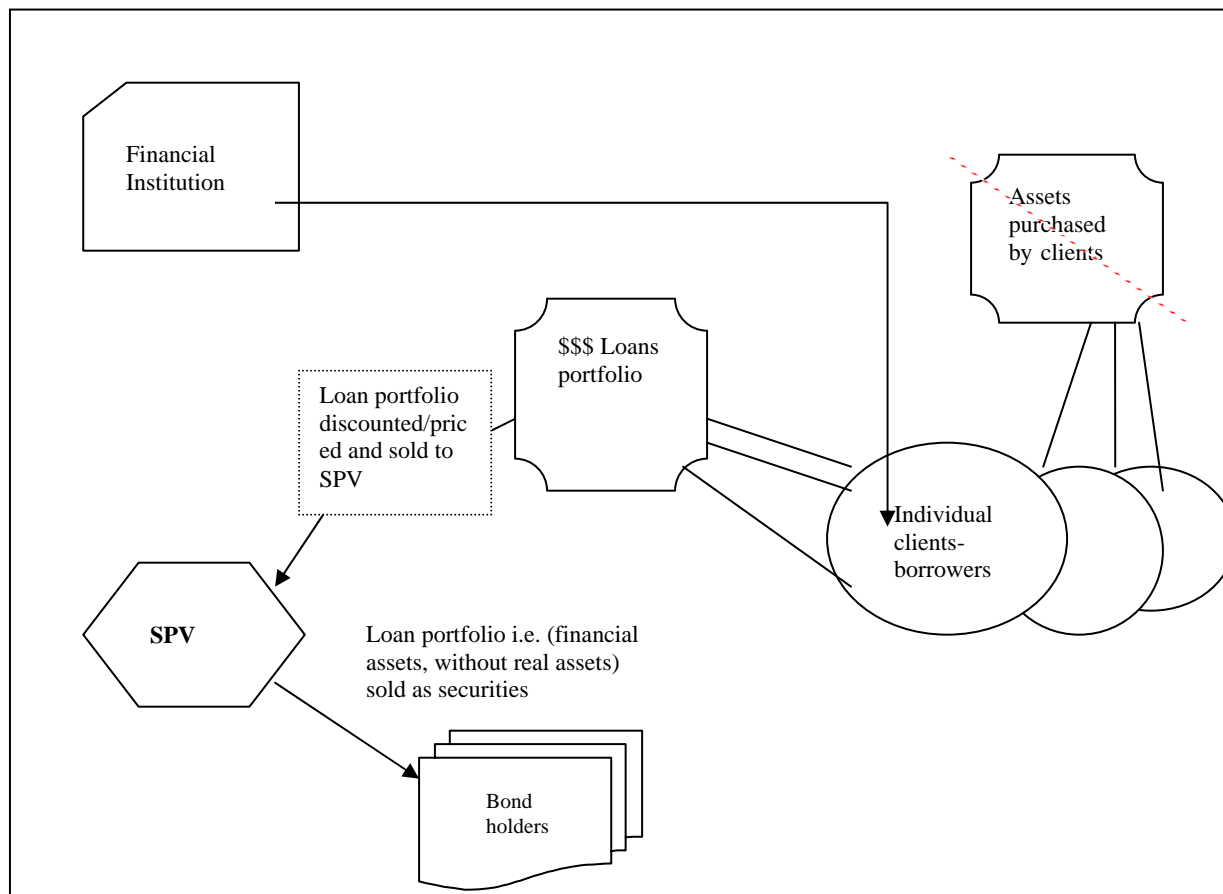
Conventional banks and mortgage houses securitize their loan portfolios from time to time, by selling their loan portfolios at an agreed price (inclusive of a margin) to an intermediate entity, like the Government's special purpose entity²⁴, or through its wholly owned subsidiary (usually called a Special Purpose Vehicle) assigned the role of a one-time or multiple issuance and management of bonds. Hence the originator (financial Institution) of securitization converts its outstanding loans into securities sold to investors. Whether the bonds are issued by the bank's SPV or by another entity which purchases the loan portfolio and then securitizes it, the bank is able to generate cash flows in a short span of time for the (usually long term) loans.

The conventional mechanism of securitization involves pricing of the loan portfolio to the seller, who in turn settles the price in return for a long term flow of funds. The risk in repayment is also estimated and priced. Similarly, in many instances, credit tranching is done by banks to offer separate tranches of bonds (as junior, mezzanine and senior) at different rates of return, based on the types or level of embedded credit risk and security against risk²⁵.

²⁴ which then takes care of it, by either reselling or issuing trust certificates through a trust entity

²⁵ Elul Ronell, Economic review 2005, "The Economics of Assets Securitization".....

Figure -Conventional Securitization



If these mortgage houses and other financial institutions have made good use of the securitization structure, it is likely that the securitization structure can be a handy and powerful or effective tool for Islamic financial Institutions, provided we understand its limitations according to the Islamic Sharia’h. This point brings us to our inquiry regarding the possibilities of banks issuing sukuk, i.e. if banks were to issue sukuk, what would it entail regarding risk and return to the sukuk holders, bank depositors and bank shareholders? In the first instance, we discuss why Islamic banks should issue sukuk.

Exploring the pros and cons of Islamic financial institutions issuing sukuk:

When Islamic financial institutions purchase and sell real assets, which may or may not have their equity content, as in the case of house financings and machinery and automobiles financings (through Murabaha, ijara’h or diminishing Musharika) the banks portfolio of slow – turnover, real assets increases. It has to look for avenues to shed –of excess long term assets.

Securitization of asset portfolios of the Islamic financial institutions and generating fresh funds can be important functions for Islamic financial institutions , without divulging from the permissibility and non permissibility of the transactions. For this purpose sukuk may be one of the plausible alternatives. Similarly, this product can be utilized as an alternate source of funding

besides deposits²⁶. From **operational point of view**, banks should be able to improve efficiency if they are able to turn out a large volume of securitization transactions by shifting them out of the balance sheet and executing fresh transactions in their place. This is elaborated in Frame 1 below:

Frame 1

Suppose the size (Total assets) of a bank is say, Rs. 15 Billion, its Net Operating Income is Rs.0.4 billion and a capital base of Rs. 1 Billion according to its balance sheet. This bank can, technically speaking, produce securitized transaction through sukuk ranging in multiples of the figures on the balance sheet as follows. For example, the same bank has net outstanding contracts of Ijarah, Murabaha and Istisna'a, to the tune of Rs. 10. Billion in its balance sheet, dated 31st December Year A. This does not mean that the bank's output for the year was of Rs. 10 Billion but that at this particular time of the Year, this is the outstanding position. Suppose, out of these Rs. 10 Billion financings, the bank securitizes Rs. 6 Billion worth of the outstanding portfolio through sukuk. The net outstanding position of the Financings (a portion of the earning assets) on the Balance Sheet reduces to Rs. 4 Billion. The bank can generate further contracts of (suppose for simplicity) Rs. 6 Billion. The total outstanding contracts are worth Rs. 10 Billion again on the balance sheet, while the bank is accountable for (Rs. 10 Billion plus Rs. 6 Billion securitized assets) a total of Rs. 16 Billions worth of outstanding contracts. It is getting unencumbered revenue from Rs. 10 Billion worth of assets as on its balance sheet , while the proceeds from the off balance sheet assets belong to the investors through the SPV/Trustee. Hence in this manner, the bank is able to generate further business, through sukuk securitization.

This activity of securitization through the instrument of sukuk would be particularly useful for the Islamic banks, since, they are (doing the “Extra mile” of) participating in trading activities to earn profits , through deferred sales while at the same time competing with the conventional banks. Although they have conventionally evolved away from sale –purchase of commodities and real assets, the Islamic transactions compel them to return to it.

Hence we arrive at the following main points:

1. Securitization enables an originator (financial institution) to divest its assets and at the same time generate funds in the present time.
2. Securitization would be particularly useful for those financial institutions which undertake long term tangible contracts like house financing, financing of machinery.
3. Securitization can be easily done according to the principles of Sharia'h , by following the permissibility of transactions .
4. Sukuk as vehicles of securitization can be utilized for this purpose.
5. *Owing to its guaranteeing against any defaults by the underlying contracts, it can increase the risk exposure of financial institutions in multiples.*

As pointed out above, securitization through the instrument of sukuk, can be undertaken by financial institutions by following the principles of Sharia'h. For instance, instead of pure financial asset transactions, with no real tangible assets involved (e.g. loan contracts, or receivables only), the underlying real assets of Islamic contracts can be securitized.

²⁶ In fact there can be a bank that can function primarily on the basis of funding through sukuk operations, but we are not going to discuss it for the time being , in this paper.

Sukuk as a securitization mechanism present an avenue of improving efficiency and scale of business activity of Islamic Financial Institutions (IFIs).

In sukuk issuance, the bonds issued are termed as trust certificates and the process takes place through the Trustee entity

It is seen in general in the conventional securitizations and the sukuk securitization, that an SPV(Special Purpose Vehicle) is used in the process of securitization. Can an Islamic financial institution issue sukuk, (which are securities or trust certificates) directly or not? Should it establish a subsidiary or a Special Purpose Vehicle (SPV) for this purpose? We discuss below the requirement and role of SPV in securitization for financial institutions.

Securitization and Special Purpose Vehicle:

Traditionally, financial sectors' regulations attempted to separate the banking and securities firms and their activities., in order to contain their inherent risks, just like in some jurisdictions, there was/is a tab on the extent of banks' investment in buying shares on stock exchanges. In many jurisdictions , banks faced a barrier to directly issue investment securities in the securities market . If banks have to avail the benefits of securitization through issue of securities , they ought to resort to the mechanism of creating an SPV and trust companies for specific projects and tranches.

Why the Special Purpose Vehicle (SPV) is used ?

In Structured Finance , the use of Special Purpose Vehicles (SPV) or Special Purpose Entities(SPEs) is very common, and the usage of another entity or (SPV) as a Trustee (or the same Special Purpose Vehicle as a trustee). In other words a parent company , which, in our scenario of securitization is a Financial Institution , which off-loads or sells its assets to a self- owned, or majority owned, specially assigned entity with usually, a nominal paid-up capital but legally separate existence. It may be created for a particular securitization activity, which is usually large scale in numbers and volume, to justify the financial costs and operative requirements for its creation. Upon analysis of different sukuk structures, the usage of Special Purpose Vehicles and the Trustees was also seen. Another name for the Special Purpose Vehicle is the Protected Cell Company in some jurisdictions²⁷ .

We have taken for discussion, the example of an offshore financial center's regulatory enactment and usage of SPV or a Protected Cell Company which is a Limited Liability company. In the jurisdiction of Guernsey, The Guernsey Financial Services Commission²⁸ enacted a Guernsey Statutory Instrument namely The Protected Cell Companies (Special Purpose Vehicle) Regulations 2001, on 6th February , 2001 to incorporate or to convert a company into a protected cell company.

²⁷ This Protected Cell Company is also commonly availed in Insurance business, as seen in the jurisdiction of Guernsey Financial Services Commission.

²⁸ Bailiwick of Guernsey

Excerpts from the Guernsey Offshore area's financial services Regulations are given in Frame 2 below:

Frame 2

The Guernsey Financial Services Commission²⁹ enacted a Guernsey Statutory Instrument (No--?) namely The Protected Cell Companies (Special Purpose Vehicle) Regulations 2001, on 6th February, 2001 to incorporate or to convert a company into a protected cell company.

It includes a company established mainly for the purpose of issuing bonds, notes or loan or other debt securities or instruments, secured or unsecured. The repayment of capital and interest from these bonds, notes, etc. would be derived "from the proceeds of the company's investments including without limitation, debt or equity securities, royalties income flows, derivatives, interest rate, currency or other swaps, or any other credit enhancement arrangements or financial assets."

Secondly, it also includes any company that is mainly established for the purpose of carrying on finance business³⁰ other than the following:-

a) A company supervised under the Protection of Investors (Bailiwich of Guernsey) Law, 1987, as amended³¹;

b) A company supervised under the Insurance Business (Guernsey) Law, 1986, as amended³².

c) A company supervised under the Banking Supervision (Bailiwich of Guernsey) Law, 1994, as amended³³;

d) A company supervised under the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc. (Bailiwich of Guernsey) Law 2001³⁴.

From the above points it is clear that in this offshore jurisdiction (and it is likely in other jurisdictions too) **a banking company cannot qualify as a Protected Cell Company. It does not qualify as a company that is established mainly for the purpose of issuing bonds, notes etc.** Therefore, in order to tap the bonds market and/or avail securitization option through its own operations, it has to create another company of its own, that is very much (like) a subsidiary, that is a Protected Cell Company and is 100% owned or has majority ownership of the parent company, a bank.

Use of SPV-

The Resultant Structured Finance Products inclusive of existing sukuk structures:

This example of regulatory limitations for Financial Institutions on the one hand and the attraction of securitization as well as the available loop of Protected Cell Company (and its other

²⁹ Bailiwich of Guernsey

³⁰ "within the meaning of the Financial Services Commission (Bailiwich of Guernsey) Law 1987 (Ordres en Conseil Vol. XXX, p243; No. XX of 1991; No. Xiii of 1994; No. II of 1987; and No. I of 1998.

³¹ Ordres en Conseil Vol. XXX, p281.

³² Ordres en Conseil Vol. XXIX, p 214.

³³ Order in Council No. Xiii of 1994.

³⁴ The Project de Loi was approved by the States on the 29th November, 2000.

names in other jurisdictions) through which the bonds and trust certificates can be issued, gives rise to the structured Finance products in conventional as well as Islamic finance and banking. In conventional Asset –based securitization, the legal structure is designed in manner that enables “bankruptcy-remoteness”, i.e. the SPV is shielded or protected from any possible bankruptcy of the originator and also vice-versa. As a result, even if the originator has encountered any financial difficulty, the SPV can realize its security interest in the assets and obtain full control over cash collections. There are other legal matters to, regarding legal, accounting and fiscal status of the asset transfer³⁵ and the form of the SPV (trust, unit trust, corporation). Hence, by making the special-purpose entity, “bankruptcy remote” the security (bonds, commercial paper etc.) investors are protected³⁶.

Sukuk’s structure is one of the examples of such a structured finance product with the baseline of permissibility in Sharia’h. The sukuk structures as analyzed from their documents, validates this argument. In majority of the samples studied, the structure uses the SPV and a trustee in its process to (securitize and) issue sukuk. The SPV in most cases is a limited liability company. It may be fully owned or have majority ownership by the originator of the underlying assets and the asset contracts (whatever the case may be). It can also have majority ownership by the originator, and the rest of the ownership can be by other stakeholders. For instance, in the case of the local currency WAPDA³⁷ sukuk in Pakistan (2005), the WAPDA First Sukuk Company, a Limited Liability Company has acted as the issuer and was registered with and regulated by Securities and Exchange Commission of Pakistan. The WAPDA First Sukuk Co is 100% owned by WAPDA and acted as the Issuer SPV for the WAPDA Sukuk. WAPDA is an autonomous body and a non-bank.

The Malaysia Global Sukuk Inc. was incorporated in Labuan, Malaysia under the Offshore Companies Act, 1990 of Malaysia on 3 June 2002. The Issuer is a special purpose company formed solely for the purpose of participating in the transactions contemplated by the Transaction Documents. The authorized share capital of the Issuer is U.S.\$12,000, of which two ordinary shares of par value U.S.\$1.00 each have been issued. The Issuer’s issued ordinary shares are owned by The Minister of Finance, a body corporate established under the Minister of Finance (Incorporation) Act 1957 of Malaysia³⁸.

Hence we can conclude³⁹ that with a particular end in focus, and given the legal and regulatory system to work in, the sukuk are designed in a manner that the end is achieved, whether through a non- banking subsidiary for banks⁴⁰ or through an SPV. This design can be utilized by the Islamic financial institutions too, keeping in view its own individual targets and pre-requisites of Sharia’h permissibility as well as their regulatory requirements.

³⁵ Whether it is a true sale or not.

³⁶ Giddy. H. Ian, *Asset Securitization in Asia*, New York University, 2000

³⁷ Water and Power Development Authority (WAPDA)

³⁸ The Malaysian Global sukuk, Offering Prospectus , 2002

³⁹ from the above mentioned sample regulation and the sukuk structures

⁴⁰ to undertake issuance of bonds and sukuk (trust certificates)

Given the presumption that the above mentioned method and securitization structure is allowed by regulators for financial institutions(including Islamic financial institutions) , we shall delve into its risk and regulatory implications.

Risk in business and financial transactions

The crux of the economic dealing in Islam is that of a collective economic order⁴¹. We infer that the Islamic Business and financial concepts highlight the sharing of risk and reward among the contributors of funds and also among the users of funds. That is why, instead of giving loan for trade and business, it is considered better that the contributor of funds becomes equity holder in the business or financial venture. Equity holders are equally liable and rewarded in the business losses and profits respectively. While partnership and “Shirkat” is propagated, speculation and gambling is totally forbidden (Haraam). Similarly, efforts to safeguard against risk are allowed as long as it does not end up in the safeguard of one against the loss of other partner/shareholder. Hence, according to the inference of this author, any regulation or design of an operational system or product that causes inequitable distribution of reward and risk is defective and causes more problems in the society than “progress”. Similarly the conventional regulations regarding risk management are designed and re-designed with this end of collective economic equity and justice, in the face of the compartmentalization of risk and reward. Risk and reward regulations, especially the Islamic regulations, should be designed and enforced with the ultimate end of equitable distribution of rewards and risk in focus, while individual entities attempt to enhance their profits and reduce their risks. These regulations are a very important element in getting the best outcome out of the systems⁴² .

Risk perspective in financial regulations

Among financial regulations, the banking sector is considered to be the most regulated. Every bank or financial institution has to comply with its central governing body’s regulations, in addition to compliance to the now global governing bodies like Bank of International Settlements⁴³. They are primarily under the jurisdiction of the central bank of a country and international regulatory bodies of which the central banks are members.

The reason for its strict regulations, emanate from the banks’ (financial institutions’) usage of depositors’ money and further using (giving) that money as loans to borrowers⁴⁴. Although loans become a mechanism of allocating resources to the entities which require it for productive purposes, they bear a credit risk of delay or default in payment of loan installments and interest. Hence the whole setup of banking is confronted with a risky situation. Under the current conventional setup, without taking the risk of lending, there will be no earning from the money deposited with the banks, and no return to the depositors. This would defeat the very role of

⁴¹Savharvi,Hafz-ur Rehman . Maulana, *The Economic System of Islam*, Chapter 5,Collective Economic Order, Pakistan: Idara-e- Islamiat, 2001.

⁴² the statement applied to both conventional and Islamic systems

⁴³ or a country meeting the conditions of borrowing from The World Bank

⁴⁴ The loans become the bank assets while the deposits are the banks’ liabilities.

banking⁴⁵. Hence appropriate regulations are devised to make the banks' shareholders put enough money as equity to buffer against any losses in the business.

The regulatory net for addressing risk vis a vis the peculiar nature of Islamic banking transactions and the banking sukuk

The popular banking regulations, in the shape of prudential regulations, Basel I and Basel II regulations and others, are primarily designed with the conventional banks in focus. The conventional banks too have evolved into securitization and other synthetic forms. The securitization framework of the Basel II is very effective, in addressing the securitization issues⁴⁶. However, the real assets and trading and sale issues are unique to the Islamic Financial Institutions. IFSB's CAD and Risk Requirements and the AAOIFI standards complement Basel II in this regard. **Based on the usage of depositors' funds, banks have the responsibility of prudently using the funds and safeguarding the interests of the depositors⁴⁷.**

If Islamic financial institutions were to issue sukuk by utilizing a sukuk securitization structure, (example given in figure A), is there a possibility of impact on its risk and reward structure?

1. As in any conventional securitization, the riskiness of the balance sheet may diminish or increase with this offload and replenishment by a fresh tranche of assets portfolio, depending upon the investment strategy adopted .To put it more simply , if the securitization is used to get a good securitization deal /price for its good quality asset portfolio and replace this portfolio by a poor or weak quality asset portfolio or less diversified , and high risk portfolio, then the risk of the financial institutions is enhanced despite the securitization. Hence the net result depends upon the quality (of risk and return and diversification) of the replacement with the outgoing asset portfolio.
2. In conventional securitization by financial institutions ,when the securitization process is effected the originating financial institutions , usually complete the transactions without leaving any contingent liabilities or an insurance company takes care of any exigencies of default , on part of the Borrowers. In Islamic financial transactions, in the absence of insurance of the users of the real assets (who have the custody of the assets), there is a risk of non-payment , delay or default on the transactions, till they are settled. This is particularly true in the case of deferred Murabaha and Ijara'h transactions. To safeguard the sukuk investor, as seen in the sukuk transaction samples of sovereign and corporates issues, the issuer provides a guarantee to make good any non-payment or non-timely payment in case of any such transaction or transactions and to repurchase any returned and leftover underlying assets, when the sukuk matures. This is also seen in the Islamic Development Bank's Composite Sukuk based on Islamic financial transactions or Murabaha, Ijara'h and Istisna'a.

⁴⁵ which was created to enable the households with surplus funds to share them with the households with deficient funds at a cost or return (called interest which is "the riba" in Islam)

⁴⁶ [*Insert footnotes for references- Basel II, BCBS ...*](#)

⁴⁷ safety of deposits against bank losses from failed projects and bad credit.

- a. According to the author's viewpoint, if Islamic financial institutions also provide guarantees like those mentioned above, this would have repercussions as contingent liabilities as long as the underlying assets and transactions are outstanding and as long as the sukuk tranche is outstanding.
 - i. Therefore, this element or risk would call for adequate provisioning on part of the financial institution, for the off-balance sheet outstanding sukuk.
 - ii. Secondly, this issue of contingent liability (in the absence of risk sharing or takaful arrangements) should call for a limit or cap to be put on the extent of sukuk securitization tranches to be issued vis-a-vis its capital and deposit base. In addition, the collective sukuk issued by a banking system in a country would also be subject to the guarantee sustaining capacity of the central bank (due to the lender of last resort function of central banks) as well as under an international cap, based on the real resource generation ability of the country to back the total banking and sovereign guarantees. Private issuance of securities are not currently subject to any supervisory body's bail out nor a sovereign guarantee.

3. Equity and rent –based sukuk and risk perspective:
 For an Islamic Banking structure, the sale of securitized portfolio at a cost (without an element of interest) and without a guarantee, can only take place in the case of sale of musharika contracts to third parties /SPV in which case, based on the health /assessment of the musharika (as well as diminishing musharika) contracts, the sale without recourse to the originating bank can take place. Similarly, sale of Ijarah contracts can also take place, if the Ijarah assets belonging to the bank are sold out at an agreed price to the SPV or to an institutional buyer. These two instances of musharika and Ijarah would entail sale of assets that were in direct ownership of the bank. Therefore, their impact on the balance sheet would be of reduction in assets with a corresponding reduction in equity and the realization of profit or loss from the sale contract. This would be a securitization example where the risk of the bank would not multiply and there would be no off-balance sheet commitments left to be honoured.

4. From regulations' point of view, it is to be seen in sukuk securitization, whether the resultant off-balance sheet items would have any contingent claims on the originating bank/s or not. These may arise due to the safeguards promised/guaranteed in the sukuk contract. These can have negative repercussions for the originating bank, in case of distress from any of the parties to the underlying contracts⁴⁸. **The ability and willingness of the users and part owners of the (underlying securitized) assets to pay back is the main point of ascertaining the risk.** Although this ability is assessed at the time of executing the transaction based upon the market assessment and the managerial and technical capability of the customer, due to which the banks' securitization can be judged to be better in credit

⁴⁸ For instance a sukuk based predominantly on the securitization of housing contracts with the property as the underlying asset, can experience problems in case of downturn of the economy and consequent slump in the housing sector. The chances of many partners to ownership, defaulting on their equity installments and rent, can be increased.

risk, any downturn in a particular sector of the economy or the whole economy will change the picture, and otherwise creditworthy clients would tend to delay and default too, in such circumstances. Given such a situation, **what would be the fate of depositors' money and any participatory return** on it? This needs to be thought out by the regulators.

5. **Can there be a default by the SPV/the trustee?** The trustee /SPV have a nominal share capital and have a limited liability and are wholly owned by the originator. Therefore, technically speaking, unless the checks and balances systems of the parent and SPV are loose and some individuals manage to bungle up the funds, the SPV cannot default. The SPV is fed by funds from the underlying assets, through the bank and the funds of the investors are also not going directly through the SPV but through a central depository which maintains the accounts of the SPV/Trustee and the originator. Hence, there do not seem to be any plausible reason to suspect that the SPV would default. The default on any tranche of payment to investors can only occur if the payments from underlying contracts stop and the bank guarantees are revoked. If the bank can fulfill the guarantees, then the investors can be paid. Otherwise, the bank will also file for bankruptcy. **That would be the case of a total default. Total default** can occur due to a number of reasons, notable among them should be the following main points.
 - a. **The size of the sukuk** issue as compared to **the size** of business revenues and **capital of the bank** originating the sukuk issue.
 - b. The combined market conditions (as explained in Point 5 above) in which the underlying assets earn their revenue and the extent of diversification of the portfolio of assets of the underlying contracts.
6. In the case of sukuk securitization in banks, another stakeholder, i.e. the sukuk investor is added. While the sukuk investor invests in return for a floating or fixed rate of return, which may or may not bear any additional business risk, the depositor of the bank would be affected by the risk in securitization due to its impact on banking activities. Besides, the same underlying assets were originally financed through the depositors' funds and the common depositors are given the "rack" rate prevalent in the banking sector. This rate of return given to the depositors may be lesser than the rate of return offered to the sukuk holders. This is not deliberate credit tranching but has the same effect, and due to differential or discriminatory pricing, puts one party (usually the depositor) at a disadvantage against the other.

Analysis⁴⁹ of the sukuk investors' perspective on the current sukuk market reveals that so far the investors' decision to invest in a sukuk issue are based on the market rates for comparable sukuk or bonds in the market and then the weightage of the additional safeguards provided in the sukuk structure including the sovereign guarantee. Little emphasis, if any, is paid to the underlying asset and its revenue generating capacity. In addition, it is seen that in the sovereign (government) originated or government guaranteed sukuk, most of the big development projects encompassing the underlying assets of the sukuk represent monopolies or state-run activities. If these projects fail or run into inefficiencies and snags, the state machinery has committed itself to paying the sukuk holders and bailing out the SPV. While the sukuk holders and SPV, have

⁴⁹ Based on the author's study and analysis of the sukuk documents especially the offering prospectuses and their structures given in various articles, some of which are given in references.

nothing to worry in this context, the risk and costs would be ultimately borne by the national exchequer and the public in the shape of trickle-down effect on direct and indirect taxes and on cost of living. If financial institutions were to issue sukuk on the current structuring pattern and supported by the central bank or sovereign, the repercussions of a failed underlying project would be likewise, faced by the guarantors and the supporters, but if not structured carefully, the possibility of the financial institution going bankrupt, as a result, exist too.

Conclusion

Owing to the benefits of securitization and the success in generating funds through sukuk by sovereigns and corporates, it is small wonder now to think of the possibilities of Islamic financial institutions structuring their own sukuk.

Islamic banks cannot base their products and by-products on interest-based pricing and tranching, but they can securitize their products (like musharika assets, and Ijara'h assets) with equity content of the bank and leasing rights. Similarly, the deferred Murabaha (Deferred Sales) transactions can be securitized by giving the ownership of the underlying asset to the final sukuk holders, till the deferred Murabaha is fully retired. One retiring contract can be replaced by other contracts, if allowed in the sukuk contract. The pricing of the islamically securitized sukuk can be based on the returns from the underlying assets, i.e. the Murabaha contracts, the Ijara'h returns and returns from musharika contracts.

It is seen that, in order to attract the business of disintermediation through SPVs and trust operations across legal jurisdictions, the jurisdictions themselves have relaxed or created the legal environment for it⁵⁰. The fundamental factor in any securitization is the consequent separation of good assets from a company or financial institution, and using these assets as a backing for high quality securities. As a result of such separation, the quality of the asset-backed security is made independent of the creditworthiness of the originator. As a back lash of this securitization, the weakening of the balance sheet quality is a high probability, if not properly managed and regulated by the national, regional and international regulatory bodies.

For an effective system of Islamic financial institutions, it is necessary that effective regulations are in place for them. The perspective of safety (risk) and cost as well as fair play among stakeholders, foremost being the depositors, is to be considered. At the same time they should close all the back doors to interest (riba) and extortions. In other words any Islamic financial product should not cause benefit to one stakeholder at the cost of another. All stakeholders should equally benefit, proportionate to their share in equity.

Finally, a word on the pricing of sukuk structures is worth mentioning. In Ijara'h and Composite sukuk in particular, de-linking from the money market pricing benchmarks, and creating a more equity-related impact, should be the linking of pricing to the actual returns (and risks) from the underlying assets and projects. This would bring the importance of the underlying assets and the underlying projects in the limelight for every decision, by originators, as well as investors. The asset-based and equity-based products would truly reflect the asset and equity content and impact.

⁵⁰ [in order to accommodate Special Purpose Vehicles easily](#)

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