Securitization: An Important Recipe for Islamic Banks – A Survey

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Abstract: Securitisation is a concept that originated in the US in the 1970s. Within a few decades, it gained acceptance as a very important financial product within the conventional banking sector. Its advantages definitely overshadow its disadvantages; as a result it is an important financial instrument for government, banks and commercial firms. Its special characteristics for banks are that it can be traded off-balance sheet and it can be geared on a highly asset-backed level. These two points help in alleviating the capital adequacy ratio issues. However, due to the unique Islamic-ethical nature of the Islamic finance, there are certain teething problems that Islamic banks are facing to launch the securitisation policies. Consequently, until now it has remained within a limited market. The increasing trend towards securitisation in the banking sector reflects the health of this product on the world market. Islamic banks should develop it to keep pace with the financial evolution but within the parameter of *Sharīʿah*.

I. Introduction

The synergy effect of globalization is more manifesting in countries with strong banking systems (Greenbuam and Thakor; 1995: 388–90). As financial intermediaries, banks are responding to the high demand for cash flows from the multinationals to accelerate the globalization process. Hence, if Islamic banks want to be in tune with

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present economic trend, and given the present *status quo* of many Islamic banks, they will have little space in which to manoeuvre. For the last ten years the assets on average of the Islamic banking industry have remained at the conservative figure of US$ 300 bn, which is very small as compared to the mainstream sector.

One of the main trends in the banking sector to generate cash inflows is by means of the securitization process. Banks have deemed it necessary to shift their strategies in order to be in line with the global demand for money.[1] In fact experts are forecasting that in the next ten years securitization will eclipse the traditional banking loans (Chew, 1992:55). Under the traditional lending system the same institution would originate the loan, structure the terms, absorb the credit risk, fund the asset, and service the collection of principal payments and interest. Under the new system, several different institutions may be involved, each with a different function. One institution may originate the loan, a second structure the transaction into security, a third insure the credit risk, a fourth place the security with an investor and trade the security in the secondary market, and a fifth service the underlying loans (Chew, 1992:53). As a result, risk management (and portfolio management) can be more efficient and cash inflows increased. Therefore Islamic banks have to consider this phenomenon when developing their financial products.

An attempt will be made in this paper:

(i) to explain the concept of securitization;
(ii) to analyze the reasons for and benefits of the shift towards securitization, as well as the possible disadvantages;
(iii) to shed some light on the mechanism used in securitizing assets;
(iv) to see how securitization affects financial intermediaries, and
(v) to assess securitization from an Islamic perspective.

Given that securitization is a relatively new product, problems were encountered in collecting data and information related to Islamic banks for the present paper. Most of the literature studies derived from conference papers, magazines and websites.

II. Securitization: A Conceptual Inquiry

The term 'securitization' in its widest sense covers every process which converts a contractual financial relation into a transaction (Kothari, n.d.: 2). However, as it has been evolving in the financial sector, securitization is acquiring a different, particular 'look'. In present-day capital market activity, securitization has acquired a typical meaning of its own, which, for the sake of distinction, is called 'asset securitization', and the market for it is often referred to as the market for Asset-Backed Securitization (ABS) (Greenbaum and Thakor, 1995:387).

Kothari (n.d.: 3) has defined securitization as the process of integration and differentiation, which is explained below. Nicolle (n.d.: 2) has defined it as a method of funding receivables of whatever kind (mortgages, loans, credit card balance, *etc.*). Sometimes it involves producing bearer asset-backed securities which can be fully traded (and which are normally rated) secured on portfolio receivables. Brady (1998: 3) explains securitization as a process whereby a pool of similar loans (e.g. residential mortgages) or other financial assets are packaged and sold in the form of marketable securities. This has the effect of transforming long-term illiquid assets into tradable assets. The Syariah Advisory Council of Malaysia explains it as a process of issuing securities by selling financial assets identified as an underlying asset of a third party (Securities Commission of Malaysia, 2002:47).

In the light of the various definitions, securitization can be summarised as a blend of two forces – structured financial engineering and capital markets. This should be contrasted with conventional loans as a mode of financing. Securitization leads to structured finance because the resulting security is not a generic risk of the entity that securitizes its assets, but specific assets or cash flows of such entity. Also securitization creates a capital market product – i.e. it results in creating a security, which is a marketable product. The idea behind securitization can be understood as *a process of commoditization* – the outcome of the process is taken to the capital market through the creation of certain financial instruments – which can be placed in the market and – which may reduce the cost of borrowing. The process can be understood as *a process of integration and differentiation* – as explained earlier, the entity that securitizes its assets first pools them together into a common hotchpotch. This process is known as integration. Securitization entails *a process of deconstruction of an entity* – if one envisages an entity's assets as composed of claims to various cash flows, splits these cash flows apart into different 'buckets', classifies them, and sells them to different investors to suit their needs. This, breaking up of the entity into various subsets (Kothari, n.d.: 4) is known as differentiation.

III. Origin of Securitization

The first recorded case of securitization is the one initiated by the Government National Mortgage Association (GNMA) in the USA in 1970. The GNMA developed the 'pass-through', a mortgage-backed security collateralized by the Federal Housing Administration and Veteran Administration single family mortgage loan (Greenbaum and Thakor 1995:387). The pass-through loan-backed securities represent 'direct ownership' in a portfolio of mortgage loans that share similar maturity, interest rate, and quality characteristics. The portfolio is placed in a guarantor trust and certificates for ownership are sold directly to investors; each certificate represents a claim against the entire portfolio (for details of the various types of securitization contracts, see Greenbaum and Thakor 1995:392-94).

Banks joined the market later. In 1977 the Bank of America issued the first private-sector pass-through (Greenbaum and Thakor, 1995: 387), which was backed by conventional mortgages. The securitizing of banks did not begin until 1985. To date, securitization has been adopted by most financial institutions. Even some stock exchange markets are opening their doors to transactions in securitized bonds (Kothari, n.d.:7).

IV. Reasons to Move towards Securitization

Securitization has been evolving with time and is now gaining momentum. There are many reasons that could justify this trend. Financial markets developed in response to the need to involve a large number of investors in the market place. As the number of investors in the market place keeps increasing, the average size per investor keeps coming down – a simple rule of the market place, because growing size means involvement of a wider base of investors, who need an instrument that is easier to understand and liquid. These two needs set the stage for the evolution of financial instruments which would convert financial claims into liquid, easy to understand and homogenous products, at times carrying certified quality labels (credit ratings or security), and which would be available in small denominations to suit everyone's purse. Some assets are easier to securitize than others. Thus, securitization in a generic sense is basic to the world of finance, and it is a truism to say that securitization encapsulates the whole spectrum of financial instruments, hence the entire range of the financial market.

There are many reasons that may explain the shift in this direction. The three main parties who would benefit from securitization are the commercial firms, the banks and the government.

4.1. Advantages for commercial firms

Securitization is one way in which a company might go about financing its assets. There are generally seven reasons why companies consider securitization:

(i). *To improve their return on capital* – since securitization normally requires less capital to support it than traditional on-balance sheet funding;

(ii). *To raise finance* – when other forms of finance are not available (in a recession banks are often unwilling to lend, and during a boom banks often cannot keep up with the demand for funds);

(iii). *To improve return on assets* – securitization can be a cheap source of funds, though this is relative to the costs associated with alternative funding sources;

(iv). *To diversify the sources of accessible funding* – so that dependence upon banking or retail sources of funds is reduced;

(v). *To reduce credit exposure* – to particular assets (for instance when class of lending becomes large in relation to the balance sheet as a whole, securitization can remove some of the assets from the balance sheet);

(vi). *To match-fund certain classes of asset* – mortgage assets are technically 25-year assets, a proportion of which should be funded with long term finance; securitisation normally offers the ability to raise finance with longer maturity than is available in other funding markets;

(vii). *To achieve a regulatory advantage* – since securitization normally removes certain risks which can cause regulators some concern, there can be a beneficial result in terms of the availability of some forms of finance (for example, in the UK building societies consider securitization as a means of managing the restriction on their wholesale funding abilities (Nicolle, n.d.: 3).

4.2. Advantages and disadvantages for banks

Briefly the benefits of securitization for banks are the following (Brady, 1998):

Access to a wider investor base and cheaper sources of funding: Securities issued by a special purpose vehicle will normally have a good credit rating. Consequently the cost of obtaining funding can be lower than it would be if the bank raised funds directly by taking deposits. Also, the securities are likely to be attractive to investors who may not wish to invest in bank deposits;

Freeing up capital and improvement in return on capital: Securitization removes assets from the originating bank's balance sheet so that it frees up capital for other uses. It may also improve the return on capital as the bank will continue to earn fee income on the securitized assets;

Assistance management of assets/liability mismatches. With traditional on-balance sheet borrowing and lending, the maturity of assets tends to be much longer than the liabilities. Securitization effectively makes banks' assets more liquid, providing scope to more flexibly managed maturity mismatches;

Reduction of credit risk, interest rate and liquidity risk: Where securitization is structured appropriately, the originating bank can transfer credit, interest rate and liquidity risks to third parties;

Generation of fee income: By securitizing its assets but retaining responsibility for servicing them, a bank can earn fee income, an income stream unaffected by shifts in interest rates;

Economies of scale: A bank which does not have the capacity to increase its loan may nevertheless be able to take advantage of economies of scale in its loan origination and servicing operations if it can increase its capacity by securitizing assets, while continuing to service them in return for a fee income.

However, disadvantages and risks exist. Some of these are:

Retention of credit risk: Third party credit enhancement can be expensive. Thus banks will often provide credit enhancements themselves. The idea is to shift assets off balance sheet. In some cases this may leave the bank with as much credit risk as it would have if it had retained the loans itself. This is because only a certain portion of borrowers can be expected to default on their loans. Only if losses rise well above historical levels (usually when over collateralized) will the bank be better off than it would have been if it had retained the loans itself;

Provision of services on other than arm's length terms: Banks which have securitized loans often provide various administration and banking services to the special purpose vehicle, which holds the loans. Where such services are provided on more favourable terms and conditions than would apply to an unrelated party, the bank may be effectively absorbing credit losses on the loans without explicitly recognizing that this is what is happening;

Implicit risk: If a securitized pool of loans does not behave as expected and losses rise to a level where security holders could lose money, the bank may feel morally obliged to bail out the special purpose vehicle or to make good investors' losses, even though it is not legally obliged to do so. This may happen because the bank needs to protect its good name and its relationship with customers;

Reduction in asset quality: There is a risk that banks will securitize all of their best assets, thereby lowering the overall quality of assets on the balance sheet, since the better quality assets are more likely to be suitable for securitization. The issue for supervisors here is not only whether capital requirements on a bank's residual risk in securities assets are appropriate. They also need to be concerned with the sufficiency of regulatory capital requirements on the riskier assets remaining on the books;

Costs: Securitization schemes can be expensive to set up and operate, particularly where the volume of assets to be securitized is not large. There are legal and rating agencies costs and other costs involved. In practice this can make securitization uneconomic;

Limits of operational flexibility: Procedures for managing the loans and dealing with arrears must be agreed in advance. This limits the bank's flexibility in managing customer relationships and carrying out administrative procedures;

Complexity. Securitization schemes can be extremely complex. As a result, it may be difficult for the bank to ensure that all risks arising from securitization are recognized and appropriately managed (Brady, 1998: 6–7).

4.3. Advantages for governments and economic impact of securitization

Government can use securitization techniques which have a number of potential public policy uses. These include more efficient financing, improved balance sheet, better risk management and improved fiscal policy. However, two factors limit the extent to which these advantages are achievable.

First, the sovereign power to tax provides the government with low borrowing costs that, under most foreseeable fiscal circumstances, make securitization a relatively expensive financing option. Second, the multitude and adversity of financial exposures that affect the government's balance sheet make it difficult to quantify the risk management benefits of securitization.

There is scope for the use of securitization to enhance fiscal credibility, particularly in the area of superannuation where sustainability and policy credibility are crucial determinants of successful policy. A pre-requisite for successful securitization of the government's pension liabilities will be a fiscally sustainable expenditure profile and efficient management of any supporting assets (Davis, 2000: 16).

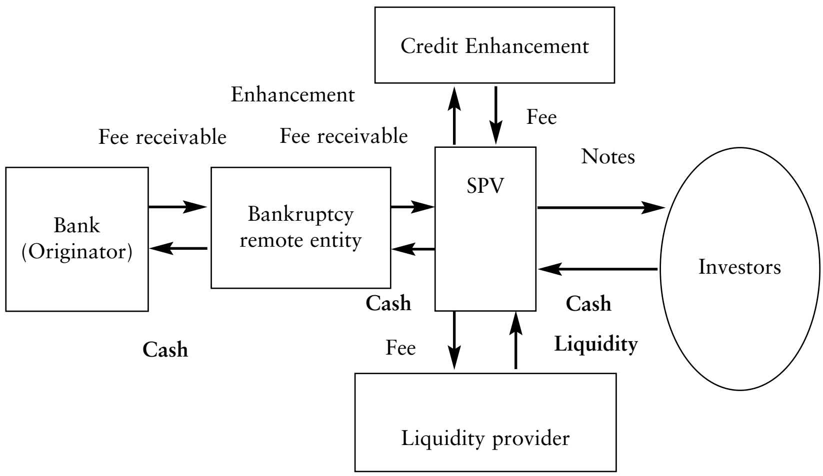
Securitization can be viewed as an economic tool for governments because it can have many economic impacts, such as facilitating creation of markets in financial claims, dispersing holding of financial assets, promoting savings, reducing costs, diversifying risks and focusing on use of resources, and not their ownership (for further details, see Kothari, n.d.: 18-21).

All these advantages support the argument that securitization will be a growing industry in the future. Hence, Islamic banks should consider their financial products under securitization process as well.

However, the methods to securitize any asset need to be understood, and then adjusted to satisfy Islamic norms.

V. The Steps Involved in Securitization

There is no standard method of securitization and new techniques are being developed all the time. However, for the purpose of this assignment securitization from a conventional bank's perspective will be discussed. The most common steps in securitization are the following as depicted in the diagram:



Source: Jeffrey, 2002

5.1. Selection of a pool of loans

The first stage in the process is the selection of a homogeneous pool of loans, e.g. credit cards receivables or residential mortgages. It is essential that the pool contains a large number of loans and that the loans are as similar to one another as possible. This allows statistical predictions about future behaviour to be made. In particular, it enables reasonably accurate predictions of default rates to be made. This allows the securities to be structured in a way which largely insulates investors from credit risk.

Banks can securitize their own loans, or they may securitize loans purchased from a third party, in which case the third party would be the originators rather than the bank.

5.2. Sale to a special purpose vehicle

Once a suitably large portfolio of assets has been originated, the assets are analysed as a portfolio, and then sold or assigned to a third party which is normally a special purpose vehicle company (SPV) formed for the specific purpose of funding the assets. Basically there should be a transfer of receivables to a separate entity. In legal parlance, transfer of receivables is called 'assignment of receivables'. There should be a true sale of the receivables, and not merely a financing against security of receivables. This enables the bank/originator to get assets off the balance sheet.

The rationale for creating the SPV is that, since securitization involves a transfer of receivables from the originator, it would be inconvenient, to the extent of being impossible, to transfer such receivables to the investors directly, since the receivables are as diverse as the investors themselves. Besides, the base investors could keep on changing, as the resulting security is essentially a marketable security. Therefore it is necessary to bring in an intermediary that would hold the receivables on behalf of the investors. This entity is created for the purpose of the transaction, hence its description as an SPV. Its function could stretch from being a pure conduit or intermediary vehicle, to a more active role in reinvesting or reshaping the cash flows arising from assets transferred to it, which is something that would depend on the end objectives of the securitization exercise.

Since the SPV cannot have any employees, the administration of the SPV's assets has to be wholly subcontracted. One of the principal documents regulating the SPV is the Administration Agreement. This is a contract normally between the SPV and the originator (who acts also in an administrative capacity), which describes all the different tasks which are necessary to permit the SPV to conduct its business, such as the collection of cash each day; operating bank account; and taxation (in the UK this normally extends to Corporation Tax, Advance Corporation Tax, VAT, withholding taxes and Stamp Duty). There is also a bankruptcy remote clause, which is a legal protection against claims arising from the bankruptcy of the originator, limiting the credit risk by investors to the assets of the SPV.

Therefore, the administration of the assets is then usually subcontracted back to the originator (i.e. the bank in this instance).

5.3. Issuing of securities

Once the SPV owns the assets, it will issue securities (e.g. bonds) to fund the purchase of the loans from the bank. The securities are structured so that interest and principal are supported by cash flows from the underlying pool of loans. However, the interest rate on securities will typically be linked to wholesale interest rates rather than to the interest rate of the underlying assets. Where wholesale interest rates are lower than retail rates, funding cost can be reduced.

5.4. Provision of credit enhancement

To make the securities issued by the SPV attractive to investors and enable funding to be obtained at favourable interest rates, it is necessary to ensure that there is little risk of investors losing money. More important still is that the risk of loss should be transparent and not just low. Usually this is achieved by incorporating a provision of one or more credit enhancements in the contract. A credit enhancement is simply an arrangement which provides protection against credit risk (i.e. risk that borrowers will not repay the funds borrowed). Normally credit enhancements will cover losses up to a level which is several times the level recorded historically, so that the likelihood of any loss for investors is very low. Commonly used credit enhancements include the following:

(i) Third party insurance;
(ii) Over collateralization – when the face value of the loans held by the SPV exceeds the value of the securities it has issued;
(iii) Issuing subordinated securities – holders of the subordinated securities take most or all of the credit risk on the loans because they receive payments only after other securities have been paid;
(iv) A guarantee from a third party;
(v) The bank being obliged to take back non-performing loans;
(vi) A one-off gift to the SPV to provide a buffer against which losses can be written off.

5.5. Liquidity support

Some form of liquidity support (e.g. an overdraft facility) is usually arranged so that security holders receive interest payments on time even if some borrowers are a little late in making payments.

5.6. Protection against basic risk

Unless returns for investors are linked to the rate of interest on the underlying assets, there is a risk that the relationship between the rate paid on the underlying assets and that paid on the securities will differ over time. Normally a swap will be arranged to protect against this risk.

5.7. Servicing loans

Someone will be appointed to service the loans in return for a fee. This involves administration of the loans including the collection of interest and principal payments security where necessary. In most cases the bank which originated the loans will carry out the servicing role. This means that the customer's relationship with the originating bank remains undisturbed and customers will be aware that their loans have been securitized.

VI. Problems of Securitization for Islamic Banks

What has been discussed above is the securitization mechanism for conventional banks. However, as Islamic banking is still in its infancy, it tends to develop financial products in line with banking regulations and also by adjusting conventional banking products to Islamic norms. The real difference between conventional securitization and Islamic securitization is that the former deals in cash-flows while the latter deals in the underlying assets. Securitization is definitely a product for Islamic banks to adopt because (as discussed previously) it is considered the future of banking. However, there are some problems for Islamic banks to resolve in adopting the tool of securitization. Some are discussed below:

The securitization model discussed above is not fully Shari'ah compliant. Some of the shortcomings are: (a) Interest is the basis for conventional transaction when issuing bonds, but this is not the case for the Islamic counterpart. Hence, *sukuk* usually are issued instead of bonds; (b) When seeking credit enhancement, the insurance issue will have to be considered as the *takaful* industry is not well developed worldwide; (c) With regard to the liquidity issue, overdraft facilities are not acceptable due to their usurious nature; (d) Also the swap used in protecting against basic risk is not Islamic according to most Muslim scholars because it constitutes exchange of money for money and because interest is involved.

Given that the dominating financial product is the *murābaḥah* (cost plus sale), it is difficult for Islamic banks to securitize as this will tantamount to sale of debt for cash which is pure interest (*ribā*), unless the amount traded remains the same or there is a mixed portfolio (Usmani, 1998:147);

The second best product for securitization is *ijārah wa-iqtinā'* (leasing with option of purchase). However, there are some practical problems that can be faced. For example the Administration Agreement may contain clauses such as the maintenance of assets should be the responsibility of the bank (the lessee) which is not permissible in Islamic law (Usmani 1998: 174). *mushārakah ṣukūk* has also been devised;

Structuring the *ṣukūk* is complicated because it should be differentiated from bonds, which are well established on the secondary markets. Unlike bonds *ṣukūk* need to be asset backed, when issued by the SPV. One of the problems to consider is the capital adequacy ratio;

Tax implications are often a spoke in the wheel for Islamic banks' because the amounts are pre-determined or can be reviewed subject to certain conditions;

Ratings are a problem in that Islamic banks often fail to reach the standard required of conventional banks (see Ons, 2002: 471-525). Thus scoring a low rating may discourage investors from buying the *ṣukūk* (ways out of this are, however, being thought about);

The concept of the SPV may be considered a deception in that often the originator itself owns it. Thus it can be argued that there is a *ḥawāla* to oneself, which Islamically is not right (Badawi, 1998:471–525). There must be a true sale;

Another question being raised is the issue of the legitimacy of the cash inflows when selling the *ṣukūk* to investors. Usually all types of investors exist and they are the ones in fact directly helping the originator to build its assets by contributing to the cash flows (Majid, 2004);

The absence of a secondary market for *ṣukūk* is a real problem. So far most stock exchanges do not allow the floating of *ṣukūk* on the formally organized markets. Also lay-people are not conversant with *ṣukūk* as compared to shares. This may affect the effectiveness of securitization for Islamic banks. The problem in creating an Islamic secondary market is: firstly the *Sharīʿah credibility* of the value of the *ṣukūk*. That value has to at least 51% asset backed, which limits the market. Secondly, there will be an issue of *credit quality* in that to find a proper guarantee for the credit risk. This in turn affects the ratings. *Liquidity* is another problem because there appears to be a general lack of short-term asset-backed products in the market. Another issue is that of *yield*. Islamic financial institutions maintain a high proportion (on average 45%) of their total assets as liquid assets.. As most investment Islamic financial institutions face another problem regarding the secondary market is the internationalisation of transactions by means of technological advancement. Islamic banks to be able to competent on the world market have not attended these.

It is difficult for an Islamic bank to really by-pass the issue of *ribā* in the securitization process. If one is to issue *ṣukūk* on market, an appropriate internal rate of return needs to be stipulated to assure the investor to some degree regarding return on their investments. This in itself is a debate that has not been settled by scholars. Also, to have credit enhancement involves an interest-based institution, such as a full-fledged insurance company. So far, many countries do not have such an Islamic set up;

Usually there is a bankruptcy remote clause in the contract which aims at giving legal protection against claims arising from the bankruptcy of the originator (bank), limiting the credit risk faced by the investors to the assets. It can be argued that if the bank has sold the asset to the SPV how can one be responsible for the asset it is leasing from the SPV? On the other hand, if the asset is destroyed, who will be responsible? In the case of *ijārah*, the lessee is not responsible unless there is gross negligence (Usmani. 1998:174).

Experts have offered some solutions and many papers have been written on this issue: for example at the Second International Banking and Finance Conference on 'Securitization and Capital Markets', Beirut, 12th-13th March 2002). Problems still exist because there are differences between Islamic securitization and its conventional counterpart. The following chart reflects some of them:

Table 1: Difference between Islamic and Conventional Securitization

Criteria	Islamic	Conventional
Asset composition	single asset	multi-asset
Guaranteed	usually	sometimes
Credit rated by agencies	occasionally	yes
Tranching of cashflows	no	yes
Secondary market liquidity	limited	substantial
Market size	USD billions?	USD multi-trillion

Source: Weist, 2003.

Among the major obstacles to wider use of securitization, one is the attitude of the Muslim investors: they are simply not well acquainted with this product for the present, it is mainly Muslim governments that are availing themselves of it. Another problem is that of accommodating *Sharīʿah* norms and values within a non-Islamic legal system – it will take some time before regulations can be changed to implement one hundred percent *Sharīʿah* compliant products. We submit, however, that Islamic banking must strive to this end, just as they have had to do for other products until a proper solution is found.

VII. Securitization and Financial Disintermediation

Despite the problems that are faced in developing securitization, Islamic banks will remain financial intermediaries. The institution of financial intermediary initially came into being to minimize the difficulties in a direct lender–borrower contractual relation between the investor (lender/depositor) and the companies (borrower), namely transactional difficulty, informational difficulty and perceived risk (Kothari, n.d.: 15).

Securitization of loans as bonds or debentures meets all three of those difficulties, and so avoids the need for direct intermediation. It overcomes the transactional difficulty by breaking the lump loan into marketable lots. It overcomes informational difficulty because the securitized product is offered generally by way of a public offer, and its essential features are well disclosed. It overcomes the perceived risk difficulty in that, the instrument is generally well secured and is rated for the investors' satisfaction.

Thus, it would be true to say that securitization leads to a degree of disintermediation. Disintermediation is an important objective of a present-day corporate treasurer: by leap-frogging the intermediary, the company aims to reduce the cost of its finances. Accordingly, securitization has been used for disintermediation.

However, securitization does not eliminate the need for intermediaries: rather, it redefines the intermediary's loan. The intermediary is still useful in serving as an investment bank or credit enhancer in the securitization process. Or it may be involved in the issuing of debentures or act as the SPV.

In short, securitization may change the basic role of financial intermediaries without eliminating the need for them. It seeks to eliminate funds-based financial intermediaries by fee-based distributors. In the case of a direct loan, the lending bank was performing several intermediary functions: it was a distributor in the sense that it raised its own finance from a large number of small investors; it was appraising and assessing the credit risks in extending the corporate loan, and having extended it, it was managing the same. Securitization separates these intermediary functions and shares them among different agents – the bank (investment), the credit-rating agency (appraisal), and a mutual fund (management of the portfolios of security). Securitization in this way replaces fund-based services by several fee-based services.

Traditional bank lending has four functions:

(i) Originating, i.e. making loans;
(ii) Funding, meaning that the loan is held on the balance sheet;
(iii) Servicing, i.e. collecting the payment of interest and principal, and
(iv) Monitoring, i.e. conducting periodic surveillance to ensure that the borrower has maintained the financial ability to service the loan.

Securitized lending introduces the possibility of selling assets on a larger scale and eliminating the need for funding and monitoring.

The securitized lending function has only three steps: originate, sell and service. This change from a four-step process to a three-step function has been described as *fragmentation* or separation of traditional lending.

VIII. The Capital Market

As mentioned previously, securitization is a blend of structured finance and capital markets. After discussing the structured aspect and the advantages of securitization, we now turn to how the capital market fuelled securitization, as it is that market that gave momentum to the process of disintermediation.

Professional and publicly available rating of borrowers has eliminated the informational advantage of financial intermediaries. Rating agents are playing such an important and persuasive role that lay investors have growing trust in them. However, although the structure of Islamic securities is more complex than conventional securities, major rating agencies use the same techniques in analyzing and rating the Islamic securities as they do for conventional securities issues. S & P believes that the positive factors that Islamic banking brings, in terms of profitability, cheap and stable deposits, and customer loyalty, tend to be offset by weaker liquidity, greater concentration risk, and less rigorous regulatory, accounting and disclosure framework (Zaman, 2003:2–3). The rating process goes through the following stages:

(i) Review written information package prepared by the issuer;
(ii) Agency will have due diligence meetings at senior management level to deepen their understanding of the business;
(iii) Agency analysts perform the analysis and prepare a presentation for the rating committee, who provide the rating according to some criteria;
(iv) Ratings are released to issuer and on market;
(v) An ongoing contact is observed between rating agent and the issuer.

There are some listing requirements that should be met in order to be listed on the stock exchange. The Luxemburg Stock Exchange does not differentiate between conventional and Islamic securities for listing and trading on its exchange.

The development of capital markets has re-defined the role of bank regulators. A bank supervisory body is concerned about risk concentrations taken by a bank – the higher the risk, the higher the level of regulation. However, if assets are distributed through the capital market to investors the risk is dispersed so that the regulator's only concern is that the risk inherent in the product should be properly disclosed. The market sets its own price for risks – the higher the risk, the higher the return required. Free of constraints imposed by regulators and risk-averse depositors and bank shareholders, capital markets efficiency align risk preferences and tolerances with issuers (borrowers) by giving providers of funds (capital market investors) only the necessary and preferred information. Any remaining informational advantage of the bank is frequently offset by other features of the capital markets – variety of offering methods, flexibility of timing and other structural options.

As capital markets become more complete, financial intermediaries become less important as contact points between borrowers and savers. However, they become more important as specialists that: (1) complete markets by providing new products and services; (2) transfer and distribute various risks via structural deals, and (3) use their reputational capital as delegated monitors to distinguish high and low–quality borrowers, by providing third party certifications of credit worthiness. These changes represent a shift away from the administrative structures of traditional lending to market-oriented structures for allocating money and capital (Kothari, n.d.:17).

IX. Concluding Remarks: An Assessment of Securitization in the Muslim World

Statistically securitization has been concentrated mainly within the government circle in the Muslim world. However, since 2003 a marked interest is being witnessed and the market is growing. The following table and examples demonstrates this.

Top Islamic Bond Issuers 2005 - Half Yearly Result				
No.	Issuer/Borrower	Country	Amount USD$ Million	Share %
Sovereign (Issued)				
1	Government of Pakistan	Pakistan	600.00	88.3
2	Government of Bahrain	Bahrain	79.50	11.7
			679.5	**100**
Corporate (Issued)				
1	Jimah Energy Ventures	Malaysia	1275.76	23.03
2	Time Engineering (Musyarakah One Capital Bhd)	Malaysia	658.02	11.88
3	PLUS Expressway Bhd	Malaysia	634.37	11.45
4	Emirates Airlines	UAE	550.00	9.93
5	Islamic Development Bank	Saudi Arabia	500.00	9.03
6	Amlak Finance	UAE	200.00	3.61
6	Dubai Metals & Commodities Centre	UAE	200.00	3.61
6	World Bank (International Bank for Reconstruction & Development)	Malaysia	200.00	3.61
7	Durrat Sukuk Company BSC	Bahrain	152.50	2.75
8	Ranhill Powertron Sdn Bhd	Malaysia	142.14	2.57
9	Ranhill Utilities Berhad	Malaysia	142.10	2.57
10	Al Marfa'a Al Mali Sukuk Co. B.S.C (Bahrain Financial Harbour)	Bahrain	134.00	2.42
11	Commercial Real Estate Company	Kuwait	100.00	1.81
12	Lembaga Kemajuan Perusahaan Pertanian Ng. Pahang	Malaysia	78.92	1.42
13	Jimah Energy Ventures (SPV)	Malaysia	56.65	1.02
19	Oxbridge Height	Malaysia	27.37	0.49
20	Al Safeena I Ltd	UAE	26.00	0.47
	Total Amount Issued in full Table: Corporate + Sovereign			**6168.74**

Source: IFS Newsletter, www.securities.com/ifis; available at: 7 July 2005

Though there is great potential for securitization for Islamic banks both as SPV or originator of their own assets, so far the volume of transactions is very little when compared to the world market. It would seem that the Muslim community have not yet come to terms with securitization. The factors contributing to this reluctance may include the following[2]:

(i) Not finding the right assets: There is, in fact, a shortage of assets that can be securitized in a viable way;

(ii) There is no well-developed secondary market: so far only three markets have been identified for selling the *ṣukūk* – Laboane in Malaysia, the Luxemburg Stock Exchange and the Bahrain Stock Exchange;

(iii) Most Islamic financing has been done through *murābaḥah*. This makes securitization for banks difficult because it involves sale of debt for cash at a higher rate, which is tantamount to interest. However, there is a move towards *ijārah* because most *ṣukūk* are issued against an asset backed lease;

(iv) Weakness in tradability of securitization. Muslims by and large have not understood the process, which seems to them too complicated. In fact securitization is mainly done at institutional levels;

(v) Cross border taxation may be another barrier;

(vi) Consenting views: *Sharīʿah* experts hold different views as to what debt is. This uncertainty raises the issue of the acceptability on the market of securitization;

(vii) The risk involved in securitization is higher because such transactions are usually off balance sheet. The Basle Accord has not finalised the securitisation of assets properly. Much needs to be done from the regulatory point of view;

(viii) Corporate sukuk can be issued as well, and it is not highly regulated.

It is important to note that as the capital market is becoming more globalised, the rating issue is considered as a safety valve. Unfortunately, only a few Islamic securitised products have been rated with 'AAA'. Also most of the issued *ṣukūk* are sovereign ones. This is an indication that Islamic securitisation needs a great deal of improvement to be competitive on the world market. This will increase the investor base and will help in developing the *ṣukūk* secondary market, which is still in its embryonic stage.

Two crucial issues for the Islamic banks should be considered: How to marry securitisation and at the same time to play the role of financial intermediaries? Islamic banks will have to look into these two antagonistic issues. Trenching of cash flows is a main issue that they should focus on. Secondly, they need to move towards real asset-backed mode of financing to ensure the elimination of *ribā*; they should be in a position to cope with the volatility of the capital market and be more in line with Islamic mode of financing per se.

Lastly, the issue of sale of debt for debt (*bay^c al-dayn bi al-dayn)* is still a bone of contention between Muslim scholars. Therefore if one is to argue the importance for securitisation for Islamic banks, then more asset backed securitisation will be needed. In other words, Islamic banks should move away from money transaction towards asset backed transactions.

In conclusion, Siddiqi (2000) is right to argue that the success of Islamic banks will also be determined by securitization among other factors. They must be pro-active to be in line with conventional banking. The advantages of securitization far outweigh its disadvantages. However, Islamic product development needs much expertise especially when it is to be implemented in a non-Islamic legal environment. There is a need to consider amendments in both regulatory and legal aspects.

NOTES:

1. This can be gauged through the amount of transactions the banks are involved in securitisation. This phenomena is increasing at an exponential rate because many Governments themselves are using securitisation to raise money such as student loans in New Zealand, in Malaysia the latest securitisation of government land has taken place this year.
2. These remarks have been collected by interviewing experts in the field, such as Derek Weist of the Arab Investment Corporation, Mushtaq Parker, the editor of Islamic Banker.

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