

SUKUK: SHARIA'H AND REGULATORY IMPLICATIONS

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Dedicated To *Falah*

Abstract

In a global economy, not all economic units are following the same socio-economic regime, but a predominant majority is pursuing a capitalistic economic system, propagating a free market economy, with checks and balances and a good number of welfare state economies. The socio-economic system of Islam too espouses a market economy but with a system of rights and responsibilities from the smallest or weakest element to the largest and strongest socio-economic unit/s. The regulatory system of Islam, called the Sharia'h defines the nature and sphere of activities of this socio-economic system.

Innovations in Finance create new products in an effort to provide better solutions to the market. Some time passes before the products' total, real impact is felt and understood by the stakeholders and the economy. As innovators do attempt to beat or sideline the given regulations and make room for their own interests to be fulfilled, it becomes necessary to evaluate products for their true worth and meaning. This is made possible through application of regulatory clauses as well as evaluation of regulations, as new products often attempt to beat regulations. This is why it becomes all the more important to study together products and their regulatory issues, particularly discussing the products' impact on all stakeholders and the socio-economic system, as in this research.

This research work analyses sukuk structures as products of Islamic Finance and tests whether they are Sharia'h compatible products or just another name for a type of conventional bonds. It tests the sukuk attributes in comparison to the Sharia'h objectives of Islamic Finance, as given in the AAOIFI Sharia' Standards. It further tests sukuk in terms of conventional structured finance. It assesses whether sukuk transfer risk from the originator to sukuk holders or not, applying the relevant securitisation clauses of the International regulations for Financial Institutions, given by Basel II regulatory report. The results of the analyses shall clarify the position of the sukuk according to the Sharia' Standards as well as the Basel II regulations. It throws light on the possible application of sukuk by Islamic finance Institutions particularly due to the securitisation and fund generating attributes of the sukuk.

The study provides important insight into the sukuk structures through the above-mentioned synthesis. While some aspects of the sukuk comply with the AAOIFI Sharia' standards, there are others that do not. While it was expected of the sukuk as Islamic finance products, to transfer risk from originators to the sukuk holders, this was proved incorrect. This research has implications for further product development, design and usage as well as development of Sharia' Standards and International regulations within the prerequisites of the Sharia'h requirements.

Key words: Sukuk, Islamic banking, Islamic finance, regulations, risk transfer, securitization, AAOIFI Sharia' Standards, Basel II

List of Publications and Submissions

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2. **Jabeen, Z.**, Javed. M. T., “Sukuk-Structures: An Analysis of Risk-Reward Sharing And Wealth Circulation”, *The Pakistan Development Review*, Vol. 46, No. 4, Part II (2007), Journal Of Pakistan Institute of Development Economics, Islamabad, Pakistan.
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Sukuk : Sharia'h and Regulatory Implications

Chapter 1

Introduction

1.1 Background

Core economic activities which are essential for the survival and growth of an economy consist of the production of goods and services. However, business organizations can fulfill their role of producing goods and services, only if they have requisite input resources to run their business. Businesses arrange for the requisite funds, either through their own equity funds or through borrowed or debt financing. Finance is an integral part of the economic system due to the need to fund optimal resource allocation. In recent years, the financial sector has attained such rapid to exponential rates of growth, that it has achieved a unique dynamic of its own. In the financial sector there are two types of transactions. The first kind of financial transactions are driven by economic activities. The second kind consists of purely financial transactions. The latter are called “synthetic” transactions, and are devoid of any link to real output. However, in the very recent past, there has been a resurgence of real-asset-based finance in trading of goods and services. Due to its religious motivation, this phenomenon is popularly known as Islamic Finance. It is growing noticeably fast especially in the Muslim countries as well as those countries which attract wealth from Muslim sources. Current “Modern” Islamic investments, banking and business are important sources of such wealth.

The Islamic Financial system is based on real¹ economic activities, in the sense that finance does not exist separately *per se*², but is required for the allocation of economic resources. Within this framework, Islamic Financial Institutions (IFIs) cannot make a return on the basis of dealing with money, bonds and documents only, as this is *riba* (usury), which is prohibited in the Sharia'h³. On the other hand, the conventional financial institutions predominantly earn profits on the basis of money and documents involving debt based transactions, which is *riba*⁴. To remain as financial intermediaries, yet follow the Sharia', IFIs primarily undertake real assets'-based transactions, based on the principles of sharing underlying profit- and- loss or based on mark-up (to cost), representing trade activities or rent based activities. Thus, the Islamic financial products, in both the money markets and capital markets, involve transactions involving real assets and do not involve *riba*. Moreover, the new Islamic financial products that are developed to meet the needs of the customers and compete in the market are scrutinized essentially for their compatibility with the Sharia'h, besides complying with relevant conventional financial regulations.

The Sharia'h , which is the Islamic code of conduct , describes the law for the financial system, based on the divine rulings from the Qura'n , the Sunnah of the Holy Prophet Mohammad (Peace and Blessings Upon Him), and the Qiyas and Ijmah of the learned scholars in Islam, over the ages. However, the Islamic Financial system's operations and standards too are strongly affected by the drawbacks of the conventional system, which after all comprises the environment in which they operate. The Islamic Financial system is

¹ The term real asset is used here in order to differentiate them from the conventional debt-instruments which are also called assets of the intermediaries.

² Ali S Salman., (2007)

³ For a detailed discussion on the subject, refer to The Pakistan Supreme Court's Judgment on Riba at http://www.albalagh.net/Islamic_economics/riba_judgement.pdf

⁴ This is the basic definition of financial intermediation in the conventional banking system.

especially affected by the syndrome of safeguarding one's own interests, as it has to operate within a society comprised of individuals, in which divine rulings issue clear verdicts, arising from knowing the essence of human nature.

Besides AAOIFI Sharia'h Standards, which guide on Islamic product attributes, the international financial regulations draw the broad parameters for all financial institutions that want to operate internationally, as well as nationally. For Islamic financial Institutions to operate on an international level, compliance with International regulations is essential. Of particular importance is the current international convergence on minimum capital requirements for safety and robustness of the financial system. It was proposed by the Basel Committee for Banking Supervision (BCBS) through its consultative reports namely, The International Convergence of Capital measurement and Capital Standards. These reports are popularly referred to as Basel I (dated July 1988) and Basel II (June 2004). The Basel Committee for Banking Supervision is a committee of banking supervisory authorities. It was established in 1975, by the central bank governors of the Group of Thirteen countries, comprising senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It meets at the Bank for International Settlements in Basel, as its permanent secretariat. The Basel I and Basel II consultative reports of BCBS for specifying the modalities of minimum capital requirements were proposed and set, initially among member countries. Nowadays, internationally active banks observe them on a worldwide basis and have taken the shape of regulations. The minimum capital requirements (of Basel I and II) aim at regulatory convergence for strengthening and stability of International banking system, to minimize competitive inequality due to varying local regulations. They devise mechanisms for assessing the risk profiles of the financial institutions based on their extent of activities and risk based assessment of the product types.

The current research is focusing upon a unique and innovative Islamic financial product, namely sukuk, whose current usage took place from 2001 onwards. The Accounting and

Auditing Organization for Islamic Financial Institution (AAOIFI), in its Sharia' Standard No. 17 defines the Sukuk as follows:

“Investment sukuk are 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...”

Sukuk are financial products generating funds by issuing sukuk scrips of ownership or leasing and usage rights to the (sukuk) investors. In this respect, they are different from both stocks and bonds. Sukuk types include Ijara'h sukuk, Musharika sukuk , Salam sukuk and others⁵. Sukuk are currently issued on a large scale by sovereigns (governments), autonomous bodies, corporations and other institutions for funds' generation purposes.

The sukuk have witnessed extremely high market growth. The market size for sukuk was US\$40 billion in 2006, while new sukuk issued in 2007 alone were approximately US\$ 40 billion. Although novel, the sukuk are one of the few Islamic financial products, which has gained wide international acceptance. However, little research has been done on the sukuk. When the current research was initiated in 2005, no Islamic banks had issued sukuk. More recently, (2006-2007) Islamic Banks or IFIs have started issuing sukuk.

1.2 Problem Statement

Conventional as well as Islamic financial products represent and portray their own systems and the philosophy behind them. They are like the individual cells in a body, all serving the body, individually as well as collectively. Thus, if the cells malfunction or become

⁵ AAOIFI, Sharia Standards (1424H/2004-5), pp.298-300.

cancerous, the whole body gets affected and dies. The regulations of a system have a policing force in addition to grooming or developing the system, so that it avoids its inherent flaws and develops in a certain agreeable direction. In order to conserve the system and the paradigm it represents, it is very important for its stakeholders to abide by the regulations. The Sharia' Standards, inclusive of the Sharia' objectives as well as International financial regulations, perform the regulatory and developmental function of their systems. They primarily serve to better the society by delineating the rights, obligations and limitations of the systems and stakeholders. Consequently, Financial institutions are required to abide by the international regulations and Islamic financial institutions have to observe Sharia' objectives as well. For this institutional level compliance to be effective, their products and services also need to be commensurate with the principles (of Sharia'h and international regulations). Only then are the real and financial sectors of economy, consistent with the objectives of Sharia'h at the aggregate level. In this manner, a society based on the ideology of Islam can flourish, for the betterment and prosperity of all.

Main issues

Just like any market –based developments, financial product developments and innovations finance create new products, primarily based on the particular needs of institutions or investors. For instance, new products evolve to provide better regulatory and legal solutions to the market than existing products. Other examples may include better risk –based profits for diversification of investment portfolios. However, the market experiences their real impact gradually, as their effects percolate to the stakeholders as well as to the rest of the economy in due course through market dynamics. Regulators have to particularly be wary of

the innovators' attempts to beat or sideline the given regulations in order to gain profits. In addition, in a newly evolving field like Islamic finance and the Sharia'h based regulations, there is the very important need to clearly understand, apply and explain the requisite postulates, correctly, without deviating from the basic objectives. More work of this type is needed in this field as it is at a very nascent stage and needs to be developed.

It becomes necessary to evaluate new products for their actual economic substance, to clarify their position in terms of what is right and what is not, according to what is permissible and not permissible within the Sharia'h, so that the rights and obligations towards the society and stakeholders are protected. This is why it is very important to study product characteristics in tandem with their regulatory issues, while particularly discussing the products' impact on key stakeholders.

Among the regulatory concern, of utmost importance is the financial stability of the system. An important widespread barometer of financial stability is to assess the levels of capital needed to keep the financial system safe from collapse. This arises from the fact that the International conventional system is prone to collapse, if left on its own, from a multitude of reasons. However, the primary reason arises from each of the stakeholders "safeguarding their own interests".

1.3 Objectives of the research

The basic objective of the research is to find out about sukuk, and analyze their inherent nature as economic and financial instruments and their implications within the Sharia'h, arising from their practical implementation. Moreover, this study is also a test of the Sharia'h standards and the portion of International financial regulations of capital adequacy

known by the name of Basel II regulations, and an assessment of their ability to answer the particular questions that emerge during the process of analysis. This study should provide further questions to be answered by others in the ongoing process of knowing more and unearthing related matters. More specifically they should lead to the refinement of the sukuk structures, as well as further deliberations and developments in the Sharia'h Standards as well as growth of new products.

When Basel I and II were being chalked out, Islamic Financial Banking products were not introduced to the European Union and the OECD member countries. Hence if the current Islamic financial products have a different economic substance, their specific regulatory requirements may not be addressed by Basel Committee regulations, especially Basel I & II. However, Muslim countries of the world do incorporate such international regulations in their own regulations. IFSB has made some amendments in the Basel II Capital Adequacy Ratio formula for IFIs regarding their deposit taking business and their sharing of profits among the depositors. This work of IFSB was made possible only through the review the features of Basel I and II to the Islamic Financial Business. The current research through the Hypothesis No. III and IV (twin hypotheses) is doing a similar exercise, in relation to the sukuk, but with an objective of understanding the nature of sukuk. It analyses sukuk for their economic substance and their underlying risk and return profile, in order to know whether the Basel II regulations are adequate to gauge their capital adequacy requirements in Islamic financial institutions issuing sukuk for securitizing their assets and raising new funds. Secondly, it discusses the reason due to which these regulations are adequate or inadequate in the above exercise.

The thesis objectives have been presented into the following testable hypotheses.

1.3.1 Hypotheses:

Hypothesis I:

Sukuk conform to the principles of Sharia'h

Hypothesis II:

Sukuk are based on different securitization principles than that adopted in conventional instruments

Hypothesis III

In Sukuk, risk is transferred from originators to sukuk holders, which is Sharia'h compatible

Hypothesis IV:

Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.

Sukuk have been defined by the AAOIFI Sharia'h Standards (1424H/2004-5) and it has many types. Their names (e.g. Ijara'h Sukuk, Musharakah Sukuk and others) describe the underlying contracts that compose the Sukuk. The researcher has analyzed the sample Ijarah Sukuk and Musharakah Sukuk. The former represents the predominant majority while the latter represents a separate class of Sukuk based on the principles of Musharakah (partnership by contract).

Explaining Hypothesis 1:

“Sukuk conform to the principles of Sharia'h”

The Sharia Standards given by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are chosen as the yardstick for determining the sukuk's conformity to them. This implies conformity to Sharia'h as AAOIFI's statements and

standards represent the views of renowned Sharia'h Scholars in consultation with industry experts. AAOIFI is an international body that issues reports and standards for Islamic financial products and related terms, used in Islamic financial business. Extensive scrutiny and discussions among Sharia'h Scholars and industry experts take place to help develop and improve standards and make further statements.

There can be a limitation of this exercise in terms of any limitation of the AAOIFI Sharia'h standards in assessing the Sukuk from the perspectives of broader objectives of the Sharia'h. The actual contract document accompanying different sukuk when they are issued in the market, are specific to the aim and requirement of the originator and Sukuk holders. AAOIFI, on the other hand, does not provide a standard contract or its main features to use in the Sukuk contracts. Hence, the contract may or may not lead to an AAOIFI compliant sukuk, albeit in name. This can become clear upon testing the Hypothesis. It can become clear whether the Sukuk have characteristics, which are not described in the Sharia Standards and deviate from the core Sharia objectives of risk and rewards linked to the underlying businesses, the core essential of asset-based nature of Islamic finance products required in Islamic Sharia'h

Hypothesis 1 tests the following elements of the Sukuk contract for their compliance with the AAOIFI Sharia'h Standards: The underlying asset, the actual contract (of Ijara'h, Musharakah), the distribution mechanism of risk and return among the originator, the SPV, Sukuk holders, guarantees and repurchase agreement and their impact on the originator, the SPV, Sukuk holders.

Explaining Hypothesis II:

“Sukuk are based on different securitization than that adopted in conventional instruments”

Securitization is an effective tool used in conventional finance. It is used mainly by financial institutions for selling off their asset portfolios to other investors in the shape of bonds i.e. securities. Hence, the process is called securitization.

This hypothesis is explained and tested through a case-like explanatory analysis of the sukuk according to their AAOIFI based, Sharia'h specifications by discussing the impact of securitization on financial statements of financial institutions and the need for securitization in Islamic financial institutions.

Explaining Hypothesis III:

“In Sukuk, risk is transferred from the originator to the Sukuk holders”

In the actual Sukuk transactions, that were analysed from the sukuk issue prospectuses, there is a flow of transactions (or contracts) taking place from the originator to Special Purpose Vehicle to the Sukuk holders and vice versa. The Special Purpose vehicle gets ownership of the assets and further transacts with the Sukuk holders, in a manner depending upon the type of the Sukuk grafted. The Special Purpose Vehicle gets dissolved upon maturity or termination of the Sukuk. This pattern is the same as in conventional securitization. The actual impact of the composite transactions is felt by the originator and the Sukuk holders and it is important to find out how they are affected from the point of view of status of the contracts from Sharia'h standing. For example, in any sale transaction, it is necessary (or inevitable) that risk (along with the commodity transfer or service performed) gets

transferred from the seller to the buyer. This is the case even if the buyer has not paid the full price of the assets bought. In an equity participation, (say, between the originator and the Sukuk holders) the risk and rewards are shared and hence part of the business risk gets transferred from the originator to the Sukuk holders according to the contract terms. In an Ijara'h rental contract, the risk of the underlying Ijara'h asset stays with the lessor, as the lessor is the owner of the asset. Whereas the usage-related risk, (wear and tear) is the responsibility of the lessee. Hence, Hypothesis III tests these risk related attributes of the sukuk's underlying contracts by using the relevant features⁶ of regulatory report of Basel II, which tests risk transformation⁷ in all credit related products of financial intermediation and capital market products. The Basel II regulatory report assesses a financial product's economic substance rather than its outer appearance or name. Risk assessment is part of the securitisation framework within the credit risk assessment category called Pillar I, of Basel II.

Basel II (2004) and its predecessor Basel (1988) are the common names assigned to the International Convergence of Capital Measurement and Capital Standards reports. Basel I is dated July 1988 by the Basel Committee on Banking Supervision (BCBS), of the Bank of International Settlements (BIS) Switzerland and Basel II was produced in June 2004 by the same committee. The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. Basel I report (1988) proposed minimum capital levels for banks for their sound and stable operations without destabilizing the banking industry. It

⁶ Which serve as a check list in this case

⁷ In this case, risk transfer would be the appropriate word, as risk transformation applies to change of form of risk along with change of entity.

defined capital and distinguished between core and supplementary capital, core capital being the primary equity capital and unencumbered (freely available) disclosed reserves. Supplementary Capital contains reserves and hybrid debt /capital instruments plus subordinated debt. Reserves include undisclosed (undisclosed on financial statements but made known to supervisory authorities), revaluation reserves arising from formal valuation of company assets, and general provisions or general loan-loss reserves⁸ that are created against the possibility of future losses. The minimum level of total capital was set at 8% with at least 50% (4%) core capital and supplementary capital not to exceed core capital. Hybrid debt capital instruments include those instruments which bear close similarity to capital and especially have the property to “support losses on an on-going basis without triggering liquidation” (Basel I, 1988, Para 22, p.6)⁹. Subordinated term debt was not to exceed 50% of tier 1 capital.

Basel I proposed deductions of goodwill from tier 1 capital. Besides, investment made in subsidiaries, that are performing (engaged in) banking and financial activities, is to be deducted from the banks’ total capital. The purpose was to prevent “multiple uses of the same capital resources in different parts of the group”. The assets representing the investments “would not be included in total assets for the purposes of computing the ratio.” (Basel I, 1988, Para 22, p.6). Basel II made important headways in refining the regulatory requirements for financial products and introduced market discipline as well as supervisory

⁸ Initially, up to 1992 (end of the transitional period), to facilitate banks, unencumbered resources were made eligible for inclusion in supplementary capital, proposing that such items would constitute no more than 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets within the secondary elements.”

⁹ The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS).

discretion along with the securitisation framework within credit risk (i.e. Pillar I). Basel II implementation became effective in fall 2007.

It is deduced from the review of the main regulatory documents of Basel I and II, pertaining to Capital Adequacy¹⁰, that the regulators emphasize on making it obligatory for the Financial intermediaries, to have a certain minimum safety level of core equity and (then) supplementary equity as a base and buffer that absorbs shocks from their cycle of creating “assets” out of “debt portfolio”. Since the assets created are also a debt –based portfolio, any delay or default in payments due from this “asset portfolio”, would put the bank in difficulty in paying its own obligations to depositors as they fall due¹¹.

Basel II looks beyond the products’ types or names and tries to assess⁷ their economic substance. It looks at the products’ credit risk, following the conventional system of giving return and bearing loss among the parties to the exchange. From the point of view of assessing the risk weighted capital adequacy requirements for the products, the parameters of assessment are:

Who owns the assets, who bear the risk in returns and to what extent? In this regard, what measures are in place to mitigate risk and how effective they are?

For assessing the risk element, the following attributes of the Sukuk are scrutinized in particular:

1. The underlying contract , with returns pattern

10 The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), and The International Convergence of Capital Measurement and Capital Standards report (Basel II) dated June 2004, by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland.

¹¹ This discussion is from the point of view of deposit keeping and lending on interest, the main business activity of financial intermediation, developed in the predominantly capitalistic economic system.

2. Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.
3. Repurchase agreement to mitigate the risk of payment of principal.
4. The value or worth of any collateral in terms of market value
5. Any calls or put options embedded in the contract
6. The existence of amortization schedule for repayment of the obligations

The sukuk shall be assessed for these attributes.

Although Basel II's securitization framework specifically discusses credit risk transformation, its clauses are nevertheless useful in conducting the exercise for sukuk and bring out its efficacy for IFIs, for capital adequacy requirements and eventually to understand the real risk-based mechanics of the sukuk contracts.

Explaining Hypothesis IV:

“Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.”

This Hypothesis is based primarily on the results of Hypothesis III. We can say that Hypothesis III and IV are twin hypotheses, dealing with the same issue at different levels. If through Hypothesis III's test, it is proven that the sukuk structures reduce or transfer risk from the originator IFI to sukuk holders or third parties, technically speaking, the underlying assets representing the sukuk shall be risk weighted and accordingly the minimum capital requirements for IFIs shall be reduced. However, if risk is not disseminated from the originator to the sukuk holders or third parties, sukuk securitization shall not benefit the originator IFIs in concessionary risk weighting of the underlying assets and reduced capital adequacy requirements.

In conventional finance, when debt-instruments are sold through securitisation, the risk in the debt instruments (which are called assets) is transferred to the buyer (bond holders) and other third parties who may guarantee some or part of the risk in the underlying contract. Hence, the Basel II regulations were formulated in order to gauge the risk, to ascertain where it lies and to safeguard the stakeholders especially the deposit holders and the bond holders, and to keep the financial system more robust by assigning risk –weighted capital requirements based on the inherent risk related attributes of products in the financial institutions. The capital of financial institutions provides a buffer against losses.

Sukuk as defined in the AAOIFI guidelines should transfer risk from the originator to the third party/ies to which the sukuk are sold i.e. the sukuk holders. If this is so, the analysis of clauses of sukuk contracts in the light of Basel II securitisation framework would prove it in Hypothesis II. Only then the sukuk securitised assets of IFIs would be excluded from risk–weighted assets of the IFIs for assessing their capital adequacy requirement. This is an incentive mechanism built in Basel II, in order to encourage the financial institutions to mitigate risk in ways that their regulatory capital requirement is minimized and their efficiency increases. In other words if risk is getting transferred according to Sharia'h specification of the transactions of sale, Ijara'h and/ or risk is getting minimized through risk sharing in equity participation in the sukuk contracts, it is obvious that the financial intermediary's risk (as sukuk originator) shall get reduced and minimized. It shall either get transferred (hence reduced) in a sale transactions (get reduced on its balance sheet as well as off-balance sheet) or get reduced through risk sharing in equity participation (Musharakah and Mudaraba based sukuk) with the sukuk holders. Due to these reasons, the sukuk securitization, if adopted by Islamic financial institutions, shall enable them to have lower

requirements for risk-weighted capital due to lesser risks that they carry. Hence the statement of Hypothesis III that risk weighted concessions of Basel II apply to the IFIs issuing sukuk, shall be proved as true. Proving of this hypothesis shall have important bearings on Hypothesis I and II, in reinforcing their results, if all are proved to be true or false, and shall send a signal to the financial intermediation industry regarding the benefit of such a securitisation in reducing their risk –weighted capital and yet another signal to the financial regulators in making the financial system more robust and stable in the process.

This process of testing from Hypothesis I to III, shall clarify the core attributes of sukuk, by revealing whether they are like any conventional finance product, or they have features that require different regulatory treatment and different capital adequacy requirement. Of particular attention is Hypothesis III , which can also assess whether or not the Basel II securitization framework can address the risk-reducing attributes and its likewise lesser risk weighted capital requirements IFF Hypothesis I and II are proved to be true.

In the hypotheses, the three main stakeholders in the sukuk issue are the Sukuk originators, the Sukuk SPV, and the Sukuk investors. The effect of the Sukuk design is analyzed on these from Sharia'h angle and regulatory perspective as required in the individual hypotheses. The role of SPV in the Sukuk design is given particular attention as it has a legal importance but needs to be scrutinized from economic and Sharia'h perspective.

Based on the nature of business activities of IFIs, it is expected that in the near future, sukuk shall be used by IFIs for Islamically permissible securitisation and fund generation. Product usage by IFIs is subject to regulatory requirements of the financial intermediation industry. Currently risk-based capital adequacy regulations are applied to national and International

financial institutions including IFIs. The source of capital adequacy regulations are the Basel I and II documents discussed earlier. The most relevant updated version of these regulations is Basel II. Hence Basel I and II documents were studied and the sukuk scrutinized for the core risk transfer attribute. The securitisation framework of credit risk (Pillar 1) of Basel II was specifically used for the IFIs sukuk. The specific traits studied were discussed earlier.

Regarding the results of Hypothesis III, if the study reveals that sukuk securitisation in IFIs shifts all or some risk from the originator (IFI) to third party/ies, and hence qualify for complete or partial concession in calculation of risk-weighted assets of IFIs for capital adequacy requirements, this would mean that the sale and transfer of ownership and rights in sukuk conform to the AAOIFI Sharia specifications. In addition, the usage of such sukuk in IFIs shall make the Islamic Financial system more robust from the point of international capital adequacy regulations, as represented by the current Basel II report. On the contrary, if the study reveals that the sukuk securitisation in IFIs does not transfer risk from the originator (IFI) to sukuk holders and hence does not qualify for exclusion or concession in calculation of the risk weighted assets of IFIs for capital adequacy, this would mean that the sale and transfer of ownership and rights in the sukuk do not represent true sale and transfer as defined in the AAOIFI Sharia Standards. This would mean negating Hypothesis 1 too, according to the analysis of economic substance of sukuk. As a result it would require rethinking on part of the authorities, in how to improve re –design sukuk that would meet the Sharia Standards, and also how to elaborate the AAOIFI Sharia Standards in guiding the issuance of sukuk in the correct manner, complying with the principles of Sharia’h.

Overall, the results obtained shall have implications for IFIs, sukuk structures as well as AAOIFI Sharia'h Standards and to some extent on Basel II in knowing and developing their ability to gauge any specific attributes of Islamic Financial products.

1.4 Scope and Significance of the study

An important development in our current day business and financial intermediation is the emergence of regulatory standards for assessing performance of institutions and their products as well as the impact on the economy and society. These regulations may be in the form of Sharia'h standards or the international regulatory standards or both as in this research. They serve as an important benchmark for assessment and taking corrective action, discarding the inappropriate and defective developments and helping make better alternatives. In addition, they help us in moving forward towards the more important objectives of our global society, the betterment of the society. Socio-economic justice and equity in the society lies at the helm of these efforts and developments.

Since the current application of sukuk emerged on the global scene in 2002, study of sukuk has very few precedents and that too not in the same manner as the current approach. This qualitative inquiry of sukuk as Islamic finance products and delving into its utility in Islamic financial Intermediation by testing it from Sharia'h as well as International regulations of Basel II is so far unique. The analysis of the sukuk structures in the manner described in this research shall have far-reaching implications in clarifying the purpose of Sharia'h and how far in the light of the Sharia'h guidelines, the practical shape that the product(s) adopt, meet or fail to meet those Sharia'h objectives. In addition, it clarifies, what progress has been made and what can be made in fulfilling the objectives of Sharia'h. As far as financial

stability is concerned, the Sharia'h dimension and the international regulatory dimension go hand-in-hand. The means of achieving it, though, may be different. Hence through this research, both forms of rulings are applied, in order to derive one answer, which describes the product. This research spans three and a half years commencing from mid-2005 to August 26,2008 after which it was undergoing the internal and external evaluation till December 2009.

This research shall make contribution towards the broader objective of search for better products, financial stability and equity and justice (fair play) among all the stakeholders of the socio-economic system, and not just a system facilitating the owners of money capital. It is primarily based on the concept of Islamic socio-economic system as discussed in Chapter two of Literature review under the Islamic financial system. The search for better solutions is a continuous process. It won't be incorrect to say that one cannot take corrective action or make progress in the right direction unless one explores and finds out what is correct and incorrect; unearthing the mistakes were made and finding out solutions and alternatives. This is a continuous process.

1.5 Organization of the thesis

This research is presented in five chapters. The current chapter is followed by detailed review of literature in Chapter Two. It includes the literature review of the basic foundation of Islamic financial system and principles of Islamic Finance. This is followed by the structural analysis of sukuk based on study of the actual sukuk prospectuses. It further gives an account of the International banking regulations for Capital Adequacy, comprising Basel I and II reports. Chapter Three discusses the research methodology and methods applied. Chapter Four gives the analysis, with testing of the hypotheses. The research questions are

formulated as hypotheses. First of all it gives an analysis of sukuk structures from the sukuk prospectuses, followed by the test of Hypothesis No. 1 by comparing sukuk samples with the AAOIFI Sharia'h Standards. This section is followed by comparative analysis of conventional structured finance and sukuk and a subsequent test of Hypothesis 2 using the Basel II Securitization Framework. Chapter Five gives the conclusions and recommendations.

Chapter 2

Literature Review

This chapter comprises review of pertinent literature which forms the basis of our study. Since the research is from the angle of principles of Sharia'h as well as the international regulations, so is the review of literature. We commence with the review of literature on Islamic Financial system, followed by the international regulations.

2.1 Basic Foundation of Islamic Finance

2.1.1 Islamic Sharia'h

The pillars of Islam proclaim the absolute Divinity of Allah (SWT)¹² and the position of human beings (or mankind) as His vicegerents. Allah (SWT) proclaims that everything in this world and in the other worlds is created by Allah (SWT), everything belongs to Allah (SWT) and to Him all creatures shall return (in the hereafter)¹³. It proclaims accountability of actions of all to Allah (SWT)¹⁴. In addition, the human beings as His vicegerents are given the right to own property as a sacred trust or *Amanah* from Allah (SWT). While Allah (SWT) has granted some people more wealth than others, it has been done as a test of the human beings and the rules for distribution of income and wealth have been laid out in a manner that

¹² The first "pillar" of Islam is "*Tauheed*", which means belief in the oneness and supremacy of one God, Allah (SWT), the Creator of everything. To Him belongs everything in the universe/s, in heavens and on earth, and to Him all shall return and everyone shall be accounted for on the Day of Judgment after the end of this world.

¹³ Al-Qura'n (2:22;2:29,35,36,58;5:120,)

¹⁴ Al- Qura'n. The concept of accountability for all deeds of human beings before Allah (SWT) on the day of Judgment has been mentioned time and again in the Holy Qura'n

requires flow of wealth from the rich to the poor in the form of compulsory levy of *zaka't*, as well as charity and espousing socio- economic development. In addition to this the classification of factors of production and the rights to return and earnings from them also gives very clear direction to the manner of distribution (of wealth, rewards, wages, hereditary wealth) which is equitable, fair and promotes universal brotherhood instead of pitting one against another due to injustice and extortions of the weak by the powerful.

2.1.2 An Islamic Economy

In an Islamic economy the laws of Islamic *Sharia'h*¹⁵ are upheld and the economic functions are according to the *Sharia'h* guidelines (Ahmed, Ausaf. 1988, p.112). Islamic Finance is based on Islamic *Sharia'h*. The source of *Sharia'h* is the Holy Qura'n and the *Sunnah*¹⁶. The objectives of “*Sharia'h*” underlie Islamic law and Islamic code of conduct in all socio-economic matters including business, finance and banking¹⁷. Shatibi (1302 H) describes the objective of *Sharia'h* as “*Masaleh al Ibaad*” (welfare of mankind)¹⁸. Chapra (1995) explains the objective of the *Sharia'h* as collective welfare called *Falah* in *Sharia* terminology . This welfare of mankind or *Falah* means total well being of each individual in the society, irrespective of cast, creed, colour, race, sex or nationality. Welfare of mankind is referred to in terms of five main aspects of life. These are, the promotion and protection of faith (*Deen*), self (*Nafs*), posterity (*Nasl*), intellect (*Aql*), and wealth (*Maal*), not necessarily in the same

¹⁵ *Sharia'hh* means Islamic code of conduct in every aspect of life

¹⁶ *Sunnah* means the teachings and practice of the Holy Prophet Muhammad, may peace and blessings be upon him (PBUH)

¹⁷ The basis of the “*Sharia'hh*” consists of divine revelations in the Holy Qura'n and the “*Sunnah*”.

¹⁸ Masud, Khalid (1995) Shatibi's Philosophy Of Islamic Law, Islamabad: Islamic Research Institute , International Islamic University Of Islamabad, also quoting , Al Shatibi Abu Ishaq., *Al-Muwafiqaat fi Usool al-Sharia*, Dawlat Al-Tunisia, (1302 H), Tunisia

order of priority by all scholars¹⁹. In the context of one of the objectives namely the promotion of wealth (*maal*) and business, the objectives of Sharia'h are to establish a system of business and life that is fair and just, and where wealth circulates equitably in the economy, in a manner that **risk and rewards** are distributed justly among the stake holders. In this system, the clearly laid out rules of **distribution** emanate from the basic or distinctive defining of factors of production (as three factors, land , labour and capital). As a result, money in combination with enterprise is considered as capital. This makes money share the risk, in order to earn and share rewards of enterprise. The Sharia'h clearly prohibits *riba* (Interest), gambling, gharar , speculations, and hoarding of wealth in the hands of a few. These prohibitions are given in the Holy Qura'n²⁰ and further clarified in the *Sunnah*.

The business products in Islam, evolve on the basis of permissibilities and prohibitions as laid out by the Sharia'h principles which is based on the Holy Qura'n and *Sunnah*. A number of basic products have precedence of being practiced in certain circumstances during the peak time of the Islamic rule and permitted as lawful by the Prophet Mohammad (PBUH). In order to stay clear of *riba*²¹ and prohibitions²², the transactions of profitable exchange have been prescribed by Sharia'h and guided by the *Sunnah* in particular. Trade of commodities (assets) is allowed at a profit, provided the exchange is spot; the assets exist and belong to the seller. None of the parties to the exchange can insure the profit or revenue of another party to the exchange transaction. Within this framework, combinations and permutations are

¹⁹ Imām Abū Hāmid al-Ghazālī (d.505AH/1111AC), Imām Abū Ishāq al-Shātībī (d. 790/1388) , Fakhr al-Dīn al-Rāzī (d.606/1209)

²⁰ Qura'n 2:275, 2: 278 regarding *riba*, 5:90 regarding *maysir* and gambling, 83:1-6 regarding fraud. These are some of the citations,

²¹ The axiom of prohibition of *riba* emanates directly from the verses of the Holy Qura'n in very strong words, while the Sunnah gives very clear and detailed description of what is *riba* and its types and what is to be avoided in order to stay clear of *riba*.

²² “*He has explained to you that which is forbidden*”. Qura'n 6:119

allowed to make new products, meeting new needs, provided the basic rules of Sharia'h are not violated. Any price of an asset (commodity) or service shall be according to the basic Sharia'h guidelines and accordingly, the sale agreement between the buyers and sellers of the assets. Depending upon the ratio of funds contributed and work done, the profit or revenue from the underlying business is shared. The loss is shared among the funds contributors only, according to the proportion of funds (capital) of each entity or individual²³. Musharakah and Mudaraba are examples of this mode of partnership in funds and partnership in funds and services. In addition, the Ijara'h mode, which entails giving something (Asset) on rent and drawing rent from it, is also accepted for this purpose, although it is not an original mode of financing.

An Islamic code of life, inclusive of business, finance and banking, is based on fair play and justice in society. In the same spirit Islam considers the paying and charging of interest on deposits and lending as unfair, leading to inequitable distribution and concentration of wealth, and depriving the workers of their true share in production and wealth formation. This has an important link with the classification and definition of factors of production, and the distribution of wages, risk and reward.

2.1.3 The Factors of Production in Islamic Economic System

Distributive justice is a very important element of the economic system in a society. To ensure distributive justice, it is important to identify the factors of production and how those factors contribute to value addition. While the conventional economic theory identified four factors of production (land, labour, capital and enterprise or organization), the Islamic

²³ Under Mudaraba-based partnership, the owners of funds bear the loss and the services provider (mudarib) shares a proportion of the owners' profit (as agreed), without sharing any loss. In case of loss, the mudarib loses the business and reputation too.

Economic Theory recognizes three factors of production and considers them to have the primary right to wealth created. The three factors of production are capital (inclusive of enterprise), land and labour (physical and mental activity).

2.1.4 The Concept of Capital In Islamic Economics and Neo-Classical Economics

According to Islamic Economic Theory, capital alone cannot create value unless combined with enterprise and put to productive use (Mirakhor, Abbas., 2001). Hence the term “capital” includes both wealth/investment and enterprise, being collectively recognized as a factor of production (Uzair, M. 1981). In addition, a practical example of capital being a combination of enterprise and capital (investment) is shown in the present day joint stock company’s common stock holders. They provide capital on the one hand and also become part of the initial group of people who start(ed) the enterprise. In contributing their capital to the enterprise in the form of common stock, they agree to share in the profit and loss of the enterprise. In other words, they share the risk of the enterprise, and their capital can be termed as the risk capital (Uzair, M. 1981). Thus we deduce that, further value is created by combining wealth capital (or resource capital) with enterprise. Capital in the form of wealth or money alone cannot add value in isolation. Enterprise can be explained as an entrepreneurial function, initiating a business activity which can give rewards but can also end up in a loss, and the probability of return fluctuates too.

As far as entrepreneurship as a factor of production is concerned, neo-classical economics, considers it as the fourth factor of production, distinct from the other factors because of the risk taking element in an entrepreneur. However, as explained above, Islamic Economics does not consider entrepreneurship as a separate factor of production. It considers the

collective sharing of the entrepreneurial-cum business risk between contributors of capital (financial and real assets) and human efforts in the shape of entrepreneurship acumen as a factor of production. Risk taking and investing are considered to be a joint activity (Mirakhor, Abbas. 2001).

Islamic Economics defines capital as that means of production which cannot be utilized unless it is wholly consumed or changed in form. Thus it cannot be rented or leased (Usmani, I Ashraf, 2002) unless its form is changed. Thus money becomes capital if it is consumed in the process or transformed into goods or rewards of services performed (Mirakor, Abbas., 2001). This definition is similar in principle to the definition of capital in Neo-Classical economics, in which capital consists of those goods which are used to produce other goods, and investment is the creation of new capital goods (Baumol & Blinder, 1999). Capital is not defined to be money capital in investment theory, but only in terms of “real” or physical capital (goods). In deriving a rate of return for it , the rates of return on money capital of comparable tenure and risk are used as proxies (Ross, Westerfield. & Jaffe, 1999). In Finance and investment management, the distinction between capital and money becomes blurred and terms such as money capital are used to represent money which will be used to buy capital goods in the future. According to Muslim scholars, money is not capital or representative capital at any time. It is “potential capital” which, through the services and efforts of the entrepreneur, is put into productive use and converted into actual capital (Mirakhor, Abbas. 2001). The provider of money has no role in this process unless he or she is also sharing the risk of the “conversion process” and that also in the role of an equity provider and not as a lender. The entrepreneur takes on business risk and through his efforts and ability, utilizes money and other inputs in producing final goods and services, generating

revenues and profits. Current residual profits are then shared among the equity stakeholders as well as the entrepreneur even if the latter's contribution in equity capital is nil. It is this activity and acumen of the entrepreneur that entitles him or her to the profit. If the contributor of money capital (saver-investor) was a lender only as in conventional economics, he or she would lose on two counts. First, the right to further long run profits due to the current successful business and the retained earnings in business which would ensure growth. Secondly, the right to the additional profits, if the earned profits percentage is more than the interest percentage agreed with the lender. Hence it is argued that interest (given to the lender) cannot be the price of this money since money per se is not capital (Mirakhor, Abbas. 2001), without being employed in an investment activity, in which the risk is to be shared too. To further clarify the points of discussion, we shall delve on the Theory of Interest according to the Islamic Economic thought, in the next section

2.1.5 The Theory of Interest in Economics Literature

Uzair (1981) declares the explanations given for validating the use of interest as flawed. His critique on the theory of interest is briefly summarized as follows. The rationale of charging interest, the rate of interest and the supply of capital funds have been explained through various theories. The marginal productivity approach has been useful in explaining the concept of interest. In this regard, (a) Time Preference Theory, (b) Abstinence Theory and (c) Liquidity preference theory have been cited. According to the Time Preference Theory, (by Bohm-Bawerk), the preference or superiority of present over the future has been given as the reason for rewarding (remunerating) a person for contributing money by foregoing current spending and comfort. The capital formation has been explained through the "roundaboutness" of the production method, in which a primitive society is assumed and

capital is the physical capital or accumulation of capital goods. However, Uzair explains that capital accumulation is not the same as capital formation and the ensuing justification for charging interest during the period in which cash capital or “capital funds” are used. Another explanation of interest charging is given in terms of the concept of abstinence, or sacrifice made by people, in the shape of saving, which is considered as the capital funds, and hence the reward are offered to savers in the form of interest. However, in the current times those who provide capital funds do not necessarily undergo any abstinence or sacrifice (but those who invest their funds are willfully investing). This is not “forced saving”. If the Keynesian concepts are examined for their rationale of interest on money, they employ the concept of “liquidity preference” to provide justification for interest on the supply side and combine it with the marginal efficiency of capital on the demand side. According to Uzair (1981) , “the determination of interest by liquidity preference is not exactly the same as determination of interest by supply of savings or invisible funds...”. More importantly, it has not been established whether the supply of liquid funds or savings in general are determined by the rate of interest though they may be partially affected by the phenomenon. He concludes, referring to Keirstead (1959²⁴) that “economists have been hard put to explain the rationale of interest and the rate of interest” and further asserts that the theory of interest is the least clear part of the entire economic theory, because the economists’ explanations are basically validation of “something which is difficult to justify”. The concept of opportunity cost has finally been used to rationalize interest. According to the opportunity cost proponents, the rate of interest consists of three part, (a) the basic interest rate, (b) risk premium, and (c) administrative costs of processing the financial deal/s. They consider (a) plus (b) as the

²⁴ Uzair, M ., citing Keirstead,B.S.’ Capital , Investment and Profits (New York: Wiley,1959),p.50.

opportunity cost, but what and why the basic rate, is not explained in a sound manner. It is only described as the rate of interest on the risk free government securities. This is not a satisfactory conceptual explanation as the rate charged by the government is fixed by the government and is an arbitrary decision, and a constant rather than a variable.

The sources of capital funds for investment are different. If *ex post facto* basis is considered in Keynesian as well as non-Keynesian frameworks, total savings equal total investments, but economists agree that on *ex ante* basis, savings and investments may be different. Uzair (1981) asserts that the difference is because of the fact that investment is a function of entrepreneur, and saving (supply of capital) is the function of the capital provider or saver (who can be a different entity). Savings actually used for investment purposes become investments (through the combination of efforts of entrepreneur). The following are the main sources of capital investments:

- a) Retained earnings , most often , especially in the industrialized nations
- b) Equity investments, as new investments in shares. A significant part of total capital funds, and
- c) Lending on the basis of interest (in government securities, bonds and debentures of private sector and bank deposits/lending).

Alternatives a and b above do not have an interest consideration for investment²⁵ (and capital gain that may be realized in sale of shares is not interest). They represent capital combined with entrepreneurship. Hence it all the more justifies, considering capital and

²⁵ For further reading on the subject, refer to Uzair,M., “Some Conceptual and Practical Aspects of Interest-Free Banking”, Studies in Islamic Economics, 1981, The Islamic Foundation, U.K.

entrepreneurship together, sharing together the risk and rewards of enterprise and capital invested.

The separation of enterprise and capital has created not only conceptual problems but has caused practical problems in the operation of the economy. According to monetary theories of trade cycles, most of the cyclical fluctuations have resulted from an over-investment or under-investment of "cash capital" in the economy. The lack of synchronization between saving and investment on ex-ante basis has created the problems. Through the borrowed capital, which has no relationship with the voluntary saving, there is always the possibility of over-expansion resulting in lack of synchronization between saving and investment. (Uzair, M., 1981, p.43)

"If banking business is reorganized in such a manner that the depositors interested in earning some income on their deposits are required to share the profit and loss with the users of the capital funds or the entrepreneurs, a better equilibrium will emerge and a more harmonious relationship between ex ante savings and investment will be possible (Uzair, M., 1981, p.44)."

With the description of the factors of production earlier and the theory of interest and capital /entrepreneurship relationship above, the wisdom behind the axiom of Islam declaring interest (*riba*) on money as impermissible (*haram*) becomes clearer. The interest on money capital which does not share the risk of enterprise and guarantees fixed return to the owner of money capital, irrespective of the outcome of the money invested, is unfair and illogical, causing distortions in the economy. It is unfair to the other factors of production, which bear the risk and work for the enterprise. It is an unfair burden on the enterprise, especially if it is in its initial stages or in times of distress.

2.1.6 Islamic Injunctions on Riba

Islamic law prohibits charging and paying of interest on the one hand and allows profits in the form of earnings from investment of equity capital. (Khan, Tariqullah., 1996). We now look into some of the divine signs /commands according to Islam, regarding *riba*.

According to the Holy Qura'n:

*“This is because they say,: Trade is just like riba ; whereas Allah hath permitted trading and forbidden riba”*²⁶

*Al Baqarah (2: 275)*²⁷

*Allah has blighted riba and made sadaqat*²⁸ *fruitful*²⁹.

(Allah deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner)

Al Baqarah (2:276)

O Believers, take not doubled and redoubled interest (riba), and fear Allah so that you may prosper. Fear the fire which has been prepared for those who reject the faith, and obey Allah and the Prophet so that you may receive mercy”

Al ‘Imran (130-2)

That which you give as interest to increase the people’s wealth increases not with Allah; but that which you give in charity, seeking the goodwill of Allah, multiplies manifold”

Al Rum (30:39)

²⁶ Source: <http://quran.al-islam.com/Targama/DispTargam.asp?n>

²⁷ See Annex I for complete details on *riba* , in the light of the Holy Qura'n and Sunnah.

²⁸ *sadaqat* means charity and alms , (they can be monetary as well as non-monetary)

²⁹ This may also be read as “Allah deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner”(2:276)

And for their taking interest (riba) even though it was forbidden for them, and their wrongful appropriation of other people's property. We have prepared for those among them who reject faith a grievous punishment

Al-Nisa (4:161)

Therefore, the debt-based business and finance, in which the charging and paying on interest has no relation to the actual return and risk from investment are considered as unlawful and forbidden in Islamic Injunctions. *Riba* is considered as an act of injustice ((Mirakhor, Abbas., 2001).

According to the Holy Qura'n:

“O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. [2:278] If ye do it not, take notice of war from Allah and His Messenger: but if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly. [2:279]”³⁰.

The Islamic injunctions prohibit interest (*riba*) in all its forms and for all purposes. To reiterate, interest as payment for use of capital funds is totally prohibited in Islam.

2.1.7 Types Of Islamic Financial Instruments And Their Rules Of Negotiability

In the light of Islamic injunctions, only real assets' based transactions of sale and lease (Ijara'h) can earn a return as profit margin and rent respectively. Pure monetary transactions involving lending of money cannot form permissible instruments of earning since money cannot be earned on money. Once a transaction of sale or rent is undertaken

³⁰ www.al-islam.com, Kingdom of Saudi Arabia, Ministry of Islamic Affairs, Endowments, Da'wah and Guidance

on deferred payment basis , the deferred outstanding transaction comprises the debt owed. Once a debt is created, it can only be exchanged at par and hand-to-hand (spot). Instruments that represent real physical assets and usufructs are negotiable at market price (Ahmad, Ausaf & Khan, (eds.),1998). Instruments representing debts and money are different from real physical assets and usufructs, and shall follow the rules of *hawala* and *sarf* regarding their negotiability. Those instruments that represent a mix of different categories are subject to the rules relating to the dominant category. For example, if debts ratio is more as compared to others then the *hawala al dayn* rules shall apply. If the proportion of currency is relatively higher, then *sarf* rules shall apply. Similarly, if the instruments have a large portion of real/physical assets and usufructs, dominating other categories, then the rules pertaining to selling at market price shall apply regarding their negotiability.

Islamic financial instruments that are based on *mudarabah* or *musharakah* are governed by the following conditions of their issuance.

i) The principal and expected return on investment (on *mudarabah* and /or *Musharakahh* basis cannot be guaranteed.

ii) If the financial instruments were issued for specific purposes or projects, their prospectus should include full disclosure of the nature of the activities, contractual relationships and obligations between the parties involved and the ratio of profit sharing,

iii) The issuers of financial instruments should keep separate accounts for each project and must declare its profit and loss accounts at the date mentioned in the prospectus and balance sheets.

2.1.8 The issue of Asset–Backed Financing in Islamic Financial Intermediation

The function of intermediation is a core economic activity, in mobilizing resources from the resource surplus units to the resource deficient units in the economy. In fact, financial markets serve this purpose (Obaidullah M., n.d) and financial intermediaries are an important vehicle of this activity. Islamic finance also gives the same importance to financial markets and financial intermediation as long as they stays clear of *riba*. The prevalent conventional financial markets and intermediaries exist in a setup following a debt-based model of sharing of resources, driven by giving and taking interest. However, the Islamic financial system cannot work on the basis of interest-based debt system. It had to find alternative doable solutions. All Islamic economic transactions, must involve an exchange (sale or purchase) of a tangible (fungible) asset³¹, because money is not recognized as a subject-matter of trade, unless the payment or receipt of money is accompanied by a commodity or service. Money is only considered as a medium of exchange (Usmani,T., 2001). In addition, as regards debt, if debt instruments have to be exchanged with other debt instruments or with real assets and usufructs, the rule of such an exchange is based on par value equals face value, which have very little significance, if at all for earning purposes. This requirement of asset –backed financing initially raised serious practical implementation issues for the banking sector, as banking transactions (in the capitalist/conventional system) involved dealing only in money and documents. However, this matter was gradually resolved by making many products

³¹ It does not mean barter, as barter was discouraged The Holy Prophet Mohammad (PBUH) strictly discouraged barter, in order to close all back-doors to *riba*, especially in the case of different grades /qualities of the same commodity, such as dates , wheat, rice, etc. calling for the sale of one in the market at a price and then buying another commodity with the proceeds obtained , instead of exchanging one for another.

involving assets' sale or hiring for rent and deferred installment payments. For instance Deferred Murabaha transactions comprises combining real assets' trade transaction as the basis of earning a profit margin. Thus, many derived products have been devised, that are *Sharia'h* compliant asset-backed as well as meet the financing needs of the bank clients. Examples include *Ijara'h* schemes of enabling financing of vehicles and machinery for bank customers, Diminishing *Musharakah* scheme of helping collectively build houses, factories and other installations, *Bai Muajjal* (Deferred Murabaha) basis of financing raw materials for factories, besides other schemes of Islamic Finance.

2.2 Structured Finance

Besides financial intermediation, the secondary and tertiary financial activities that involve structured financial instruments have also become very common. They include custom made structured bonds and similar securitised instruments, as well as derivatives of varying nature. They are also utilized by the financial intermediation industry for fulfilling their varying objectives like selling off their assets' portfolios (debts). Structured finance gets its name from the combination or designing (structuring) of financial contracts. Complex structured finance products emerged as a result of innovation of the industry, catering to the demand of investors and many a times with the hope and effort to ride the market or overcome the expected market returns and /or risk through such product mixes. Usually different risk categories are created through tranching in structured finance. Through tranching, the cash flows from underlying assets are diverted to various asset classes in different proportions and magnitudes according to the terms of the contracts.

Previously the terms “derivatives” or derivative instruments” were very popular being innovations in finance , supposedly holding the promise of better returns than the market average Similarly the term “Structured Finance” is a finance and investment jargon for similar product structuring making a complex structure or product. However, owing to the colossal losses and bankruptcies as a result of unchecked misuse of derivatives, like in the Bearings case, the Enron’s bankruptcy and others, it brought disrepute to the use of derivatives. Very recently, in the mid to late 2008, the financial crisis in the US, emerging from the US mortgage industry’s collapse (the sub –prime mortgages) and its domino effect on the wall street, the banking and investment industry in the USA, as well as Europe and rest of the world, including Pakistan, has brought a lot of ill-repute to the whole financial industry, the asset backed securities in structured finance and financial investments. These turn of events and the loss to the whole world as a result of financial markets going haywire, have made the analysis of financial products and revisiting the basics of finance , investments and economics , all the more important. . Sukuk have been extensively explained in Chapter No. Four on sukuk. In this chapter it is attempted to delve into the core elements of the sukuk as a financial product, ratified as permissible by the Islamic Sharia’h. It is discussed from the angle of its commonalities with similar conventional finance products. Hence, the analysis of sukuk in the context of structured finance, securitisation and bond structures shall be done.

2.2.1 Derivatives and Structured Products

Literally speaking, derivatives imply a derived product. Structured finance products too are derivatives, in the sense that they are being based on or derived from basic underlying contracts, or we can simply say that derivatives are also structured finance products. Some of

the common types of structured finance are Asset backed securities (ABS), Mortgage backed securities (MBS), Collateralized debt obligations (CDOs), Collateralized Loan obligations (CLOs), Collateralized bond obligations (CBOs), Credit derivatives, Options, futures, Credit Derivatives can be defined in simple terms as contracts that are designed to transfer the risk related to total return on an asset (credit asset), below a certain threshold level, without transferring the underlying asset. In a nut shell, structured finance including derivatives are mostly complex financial contracts. Securitisation too is very much a part of structured finance. Structured finance has been misused on a number of occasions, which were unearthed during the recent years. Hence it has earned an ill repute , despite its popular usage.³²

In conventional finance, the term “asset”, emanates from the asset side of the balance sheet of a financial institution, in which a large portion comprises the debt used as an asset. If we examine a financial institution’s balance sheet, the asset side includes, cash and bank balances, investments in securities, including bonds as well as stocks (equity shares), financings that are the loans (in conventional financial institutions) and asset –backed trade debts, Ijara’h, Musharakah, Mudaraba contracts for Islamic financial institutions, The financing component of the “assets” category is the primary revenue generating activity of the financial institution. In Conventional Financial intermediation, this asset component primarily entails debt based instruments. Thus an asset-backed security means a debt security

³² Examples of misuse of structured finance include, the Enron scam (in the USA). Enron became bankrupt. It caused huge losses to all stakeholders , including shareholders and other investors, beside ill repute to the management. Enron’s actual financial position was concealed through Off Balance sheet jugglery in earnings management, and manipulations of asset backed transactions. It was a criminal act by those involved.

in conventional parlance, although literally, it does not necessarily mean that it has to be a debt security. It can be equity too, or it can be a basic asset owned by the financial institution. In conventional finance, securitisation involving credit tranching or credit enhancement in the asset (debt security), can take place, such that there can be various risk and return categories based on the same underlying asset. In addition through credit enhancements the securitised asset class can be superior in credit risk compared to the originator (parent institution) or other asset classes.

2.2.3 Scope of Fixed Income Securities in Islamic Finance

Those securities which offer a predetermined, known rate of return and principal payment are called fixed income securities. In conventional finance, different types of bonds and certificates of deposits are examples of fixed income securities (Campbell & Kracaw, 1993). However, Islamic Finance forbids those earnings which are based on a fixed return out of the amount of monetary investment made, irrespective of the outcome of the investment when put to productive use³³. This impermissibility applies to all Islamic Financial instruments, whether in the banking sector or capital markets or anywhere else. In Islamic financial practice, many sukuk issues may be commonly known as a type of fixed income securities because of the nature of their pattern of returns, despite their underlying assets. The AAOIFI Sharia'h Standards for sukuk terms the sukuk as Investment sukuk and neither bonds nor stock. To date very limited literature is available on the attributes of sukuk due to their recent application in the present-day Islamic finance since 2001.

³³ One can also refer to the Supreme Court of Pakistan's Judgment on *Riba*, (1420H/1991) for detailed view on the subject

The current research entailing the assessment of sukuk for their actual underlying economic substance is extremely important, to find out whether they are just another name for a conventional practice or actually, a truly Islamic financial products following the rules of permissibility and impermissibility according to the Sharia'h, and specified in the AAOIFI Sharia'h Standards (2003-4)

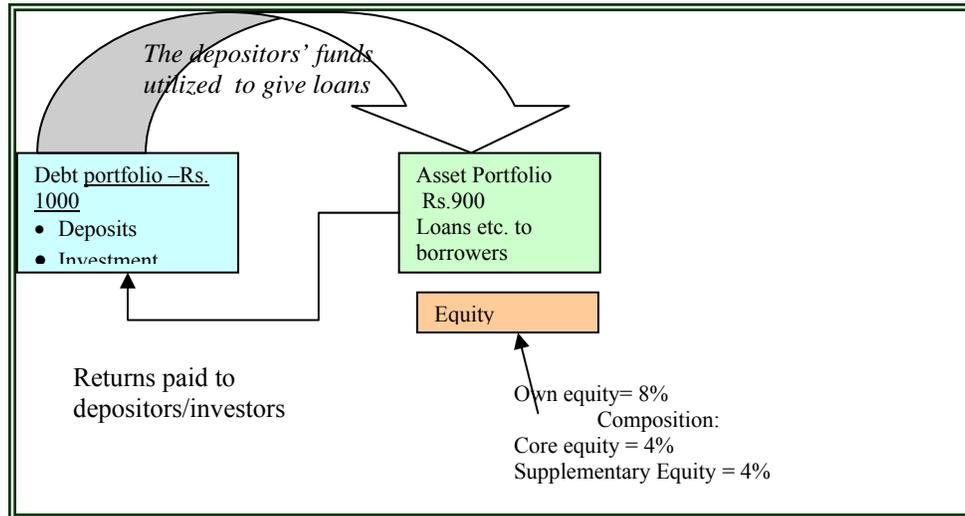
2.3 Regulations in the banking industry

The banking industry is one of the most regulated industries worldwide, owing to the fact that it is the custodian of the peoples' money which is channelized further in commercial activities, mainly through lending. Out of the numerous banking regulations, the capital adequacy regulations have a very important bearing on the banking industry operations and their business costs, while maintaining the prescribed safety capital net. These regulations of capital adequacy and risk-weighted assets serve the underlying purpose of making the financial system more robust. It lays great emphasis on safeguarding the depositors' funds, being the primary source of funds to banks. In the prevalent conventional banking system, the peoples' deposits in banks represent the bank liabilities or the debt portfolio. The banks convert this debt portfolio into an asset portfolio by lending it further for business and commercial purposes (albeit a small regulatory and safety margin) for earning its interest in turn. In the process a chain of lending and paying depositors is incumbent on pre-determined rates of interest on the principal amount lent and deposited respectively, (with the banks earning through the difference in lending and deposits rates minus its operational costs). (See Figure 2.1 below).

Figure 2.1

Conventional Banking: Fabricating Financial Assets from Debts

(The cycle of creating “assets” out of “debt portfolio” and the returns from asset portfolio being used to pay returns due on the debt portfolio)



Source: Author

2.3.1 The Capital Adequacy Regulation

Under normal conditions, a large portion of deposits remain with the banks without being withdrawn by depositors and the banks' own investments (capital, shareholders' equity) in the lending business can be very low. It can be as low as 3%. It was felt that banks (i.e. financial institutions) should maintain a minimum essential level of capital as a proportion of its time and demand liabilities in order to serve as a safety buffer against any losses. Minimum Capital Adequacy requirements were first devised and recommended by the report of The International Convergence of Capital Measurement and Capital Standards Report – namely Basel 1 in July 1988. This was later superceded by another more comprehensive report after six years, the Basel II report, which has recently been adopted internationally. In this regards, the Basel I and II reports are the main sources of the capital adequacy

regulations. The capital adequacy requirement serves to make the banking companies maintain a minimum acceptable level of own capital, for buffering the depositors' wealth against banks' lending risks. The current applicable minimum capital requirement for banks is 8% equity, of which 4% must be the core capital of owners' investment and unencumbered reserves. The Capital Adequacy requirement is considered to be providing a measure of strength to the banking system.

The purpose of capital adequacy requirements of Basel (I &) II regulations, is to protect at micro level, the stakeholders (especially the depositors) in the financial institutions, with the broad overall perspective of safeguarding the financial system from shocks and collapse. This element of shocks and collapse is conceived to be there primarily because of the leverage element embedded in the conventional financial system. As explained earlier, leverage is the use of debt. It can be debt-based investments as well as debt-based capital. Debt-based structures give and take pre-determined rates of return and do not share losses. They entail borrowing and lending based on pre determined fixed or flexible rates of return that are determined by the money demand and supply. These rates of return have no link to the underlying resource generation activities. Thus, an inflexible situation exists where any loss in business of the borrowers can render the lenders' return in jeopardy. Hence, the credit risk is created. An adequate level of capital is perceived to provide a buffer against losses in the financial intermediation business to ensure smooth operations of a banking firm and in the aggregate, the financial industry. In Islamic financial system too, an element of leverage exists due to deferred sale based transactions, rent based usage of real assets as well as installment-based transfer of ownership. However, a more "real" leverage exists, in the

practice of financial institutions, not to pass over the losses to the investor-depositors in the fear of a risk of a run on the IFIs.

Risk based capital adequacy is considered to be a remarkable improvement over simple capital base requirement as it relates the amount of capital required by a financial institution to the level of risk inherent in its products. It is perceived to gauge the level of risk in the financial institution, depending upon its products' composition. Derivatives and securitisations, apart from selling and transferring products (assets, debts) also attempt to separately sell risk to interested buyers. (Hull,1993). When derivative instruments became more common, it was more urgently felt to identify who bears what kind of risk. Basel I (BCBS, 1998) addressed credit risk of a range of products but did not cover securitisation. Six years later, Basel II was published, building upon the lessons learnt from Basel I and the historical turn of events in between, especially the creation of the European Union. Basel II has made many improvements over Basel I. It covers a comprehensive range of issues including market risk and supervisory discretion, besides much more depth in the credit risk. Among them, the Securitisation Framework within credit risk assessment, was introduced for specifically addressing risks due to securitisation and off balance sheet transactions including derivatives. Risk weighting of bank operations by assessing their deposits and loans as well as contingencies and different types of bonds are included. It enumerates minimum capital requirements for each of the instruments of the banking institutions and in the aggregate for the institutions.

For the benefit of the regulators, Basel I and now the Basel II document for capital adequacy takes a complete view of all on balance sheet as well as off balance sheet activities of financial institutions, and present a risk based regulatory treatment for international banks..

They are embedded in the prudential regulations of most of the countries, whether they are OECD members or not, like Pakistan which is a non-member. The current minimum capital adequacy ratio required for banks is 8%. In some countries, as in Pakistan there is a minimum capital amount requirement too, defining the size of a banking company to do business. In Pakistan, this minimum requirement is Rs. 2 billion, raised from Rs one billion initially (for the past few years). The general rule for all member countries and those who want to comply is the compliance with the Basel I's minimum capital requirements and provisioning and amendments from time to time³⁴.

Popularly known as Basel I, the International Convergence of Capital Measurement and Capital Standards report dated July 1988 by the Basel Committee on Banking Supervision (BCBS)³⁵ presented the committee's work on regulatory convergence for strengthening the soundness and stability of the international banking system and its application in all member countries (and preferably the whole world) with a view to be fair and to minimize competitive inequality among international banks. The framework established minimum agreed levels of capital for internationally active banks, although national authorities can adopt higher levels. It laid the foundation of further studies on the subject resulting in the much needed refinement & progress. Many years later, in June 2004, Basel II document was

³⁴ Provisioning for losses is another area which has developed extensively as it is adopted as part of the national prudential regulations of countries. Non compliance with the prudential regulations lead to penalties and disqualifications of banks. Therefore, their enforcement and compliance has become mandatory. In addition, the international financial donor agencies like the World Bank and International Monetary Fund also attach these compliance conditions of Basel I and II to the banking sector of the recipient countries. Basel II still has almost a year to go before its implementation and enforcement , and there are countries and banks which have already put it into practice.

³⁵ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

finally presented after much deliberation and scores of working papers and research work on various elements of risk and capital in the banking industry. Meanwhile, between Basel I and II, the unification of many (major) European Countries with the formation of European Community and the discussions, efforts towards one European Currency, the Euro, were the major (political, historic as well as economic) milestones in the course of time.

Basel I proposed minimum capital levels for banks for their sound and stable operations without destabilizing the banking industry. It defined capital and distinguished between core and supplementary capital, core capital being the primary equity capital and unencumbered (freely available) disclosed reserves. Supplementary Capital contains reserves and hybrid debt /capital instruments plus subordinated debt. Reserves include undisclosed (undisclosed on financial statements but made known to supervisory authorities), revaluation reserves arising from formal valuation of company assets, and general provisions or general loan-loss reserves³⁶ that are created against the possibility of future losses. The minimum level of total capital was set at 8% with at least 50% core capital and supplementary capital not to exceed core capital. Hybrid debt capital instruments include those instruments which bear close similarity to capital and especially have the property to “support losses on an on-going basis without triggering liquidation”³⁷. Subordinated term debt was not to exceed 50% of tier 1 capital.

Basel I proposed deductions of goodwill from tier 1 capital. Besides, investment made in subsidiaries, that are performing (engaged in) banking and financial activities, is to be

³⁶ Initially, up to 1992 (end of the transitional period), to facilitate banks, unencumbered resources were made eligible for inclusion in supplementary capital, proposing that such items would constitute no more than 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets within the secondary elements.”

³⁷ The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), para 22, page 6.

deducted from the banks' total capital. The purpose was to prevent "multiple uses of the same capital resources in different parts of the group". The assets representing the investments "would not be included in total assets for the purposes of computing the ratio."³⁸

For capital measurement, the committee introduced and proposed a weighted risk ratio for capital measurement as more desirable. The risk weights were used to relate capital to "different categories of assets and off-balance sheet exposures" which were "weighted according to broad categories of relative riskiness". This was done to enable a "fairer" comparison of international banks in all countries, to include off-balance sheet exposures in risk calculation and not to discourage banks from holding low risk, liquid and other assets. Six aspects of the weighted structure were given in Basel I. Main emphasis was on credit risk, i.e. the risk of failure of counterparty and its extension in the form of country transfer risk although other risks such as interest rate risk, exchange rate risk, investment risk, and concentration risk were also recognized and further studies were initiated on them. Regarding transfer risk, countries were broadly differentiated as industrialized and non-industrialized, with the industrialized group, differentiated as low risk and thus high credit rating group.

Regulations are introduced on a step by step basis as their impact gets assessed leading to further refinements and detailed work in due course. Basel I played a key role in introducing organized capital regulation, as an attempt to create a level playing field among member countries. It also broadly discussed those areas in which further work was required but at that time, a ruling on them was either not ready or the market participants were not in a position to implement them. Basel I has been, for some time, more than adequate as a capital

³⁸ The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), para 22, page 6

framework for banking institutions that engage in businesses with risks that counterparties and supervisors can evaluate relatively easily. However, for complex banks with multi dimensional activities spread across many countries and geographical areas, Basel I's simplistic approach was inadequate³⁹.

Basel I's framework categorized banks' assets into only four risk classes, specifying a risk weight (that is multiplied to the 8% minimum capital charge.). This separation had not been sufficient , especially the last category of "all other credits" . It included the highly rated Aaa as well as the B- and even the most speculative credits. This lack of differentiation, and hence a disincentive to hold good quality credit versus poor (high risk) quality credit was perceived and interpreted as high cost of good credit . This regulatory loophole provided an incentive for banks to indulge in capital arbitrage. They could sell or securitize⁴⁰ those assets whose market-imposed or market-perceived capital requirement were less than the regulatory capital. Therefore, the high quality assets could be traded or securitised in the market and banks could end up with those assets for which the regulatory capital charge was low(er). It was considered that this possibility would cause an erosion in the quality of assets and higher risk portfolio in the same category of "all others". As a result, the capital adequacy ratios of banks would not depict a true picture of the banks' true risk profiles. The ones with high-risk portfolios and others with safe loans could not be differentiated⁴¹. In other words, the

³⁹ Ferguson, Roger W, Jr,(Vice President of the Board of Governors of the US Federal Reserve System) (2003), "(his)Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Committee on Financial Services, U.S House of Representatives, Washington, D.C.,"

⁴⁰ Securitisation and Capital Arbitrage: In general securitisation means pooling assets and packaging them as securities ,which are sold to investors. Each owner of a security bears a unit of the security. If the security is backed by the asset-pool, it is called an asset-backed security. In legal terms , the holders of the security , have entitlement to the asset pool in terms of redeeming the value of their security. There are many other variations of the securities.

⁴¹ This view has been reiterated by Mr. Roger W. Ferguson, Jr. (Vice President of the Board of Governors of the US Federal Reserve System) (2003), in his testimony before the Subcommittee on Domestic and

bandwidth of “all others” category was too wide, allowing the banks to operate with minimum accepted levels of own capital and higher risk, with respect to the “perceived market risk” of the products at hand. It resulted in reduced cost of capital (within a given band) at highest risk level in that band.

One of the outcomes of regulations is the development and popularity of new or newer versions or twists in products that take advantage of any available loopholes in the regulations, till the regulators rebound and return with new improved versions or further regulations to “plug –the –gaps” and even innovate. Working around the loopholes available in Basel I led to capital arbitrage as a result of unchecked securitisation activities. Basel II, after Basel I addressed most of the innovations in securitization and tried to ensure a more comprehensive level playing field.

Six years later (1998 to 2004), Basel II’s revised framework emerged (Blount, 2004). In these six years, refinements and detailed work took place⁴². Particular attention was paid to securitisation and its framework introduced in credit risk introduced⁴³. Particularly notable are the three - tier capital, and the extensive treatment of credit risk, operational risk and market risk. Three pillars namely the minimum capital requirement as Pillar One, Supervisory Review Process as Pillar Two and the third pillar of Market Discipline has been set forth. The Minimum Capital Requirement calculations take into account the credit risk through standardized approach or /& Internal Ratings Based Approach as well as the credit risk for the securitisation framework, as the case may be. In addition to credit risk, the

International Monetary Policy, Trade and Technology, Committee on Financial Services, U.S House of Representatives, Washington, D.C

⁴² In this time frame the politico-economic scenario of Europe and the UK also changed significantly. The economic unification of members of the European Union also took place.

⁴³ Implementation of the Framework was expected as of year-end 2006, and for the most advanced approaches implementation as of year-end 2007 expected.

minimum capital requirement discusses operational risk and its weighting and trading book issues reflecting market risk, where applicable. Therefore, one can say that Basel II is quite broad based, providing for the assessment of nearly all kinds of risks within the regulatory net, be it market risk or securitisation of different kinds.

Within the Basel II credit risk assessment, the securitisation framework particularly focuses on and all products that have securitisation features. Hence we, discuss the securitisation framework, within credit risk category, as follows:

Quoting Basel II's Credit Risk – Securitisation Framework, #A⁴⁴. Scope and definitions of transactions covered under the securitisation framework, Para #538. (Basel II, 2004, p. 113)

“Banks must apply the securitisation framework for determining regulatory capital requirements on exposures arising from traditional and synthetic securitisations or similar structures that contain features common to both. Since securitisations may be structured in many different ways, the capital treatment of a securitisation exposure must be determined on the basis of its economic substance rather than its legal form. Similarly, supervisors will look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for purposes of determining regulatory capital.”

The above –mentioned section of Basel II, describes securitisation, its broad categories, and how banks exposures to a securitisation should be treated for capital adequacy purposes. It has very rightly pointed towards the significance of the “economic substance “rather than its legal shape, in determining the regulatory requirements for securitisation exposures of banks. Similarly the underlying pool being securitised may contain a variety of products ranging (as mentioned in its Para # 542) from pure loans and commitments to asset-backed and

⁴⁴ Refer to Annexures for a general discussion on Basel II and extracts from the Securitisation framework.

mortgage-backed securities, corporate bonds as well as equity securities and private equity investments. There may be a combination of such instruments in the composition of the securitised portfolio.

It has further defined originating bank as the one which directly or indirectly originates underlying exposures (Assets, loans) or it serves as a sponsor⁴⁵ of an asset-backed commercial paper (ABCP) that acquires exposures from third party entities. If a bank “manages or advises the securitisation programme, places securities into the market, or provides liquidity and /or credit enhancements,” it is considered as a sponsor. (Para 543b)

Point # 6, of Credit risk –Securitisation Framework⁴⁶ describes early amortisation provision, which can cause the certificate holders to encash their certificates before maturity, based on certain conditions, or trigger factors. This provision will be considered as controlled or uncontrolled. A controlled one must have a capital /liquidity plan in place by the bank to meet such a situation. It has a feature of “pro-rata sharing of interest, principal, expenses, losses and recoveries based on the bank’s and investor’s relative shares of the receivables outstanding at the beginning of each month.” This is throughout the duration of the transaction. “Besides it draws relationship between the amortization period and the total debt outstanding and the pace of repayment.

If any of these conditions are not met by an early amortisation provision, it will be treated as non –controlled amortisation provision.

⁴⁵ This is a debatable point,i.e. whether the sponsor is treated the same as originator. In the sample IDB sukuk prospectus (2003), the sponsors are categorically mentioned to be free of any financial guarantees or liabilities.

⁴⁶ Page 114, of “The International Convergence of Capital Measurement and Capital Standards” report (Basel II) dated June 2004 by the Basel Committee on Banking Supervision (BCBS)

In operational requirements for traditional securitisations, under IRB approaches of the securitisation framework, (Para 554), an originating bank can exclude securitised exposures from the calculation of risk weighted assets only on the conditions mentioned. Despite meeting the conditions, banks must still hold regulatory capital against any securitisation exposures they retain.

The conditions for excluding them from calculation of risk weighted assets are that (a) Significant credit risk associated with the securitised exposures has been transferred to third parties (or sukuk holders in our case).

It is very important to view regulations from the point of view of what their overall purpose is and what are they trying to gauge in their assessments, and their requirements. For our analyses, we utilize the relevant clauses of Basel II's securitisation framework within the credit risk specifically in testing sukuk for Hypothesis 2 in order to ascertain whether sukuk enable risk transfer not. This exercise is essential in order to depict any advantage or otherwise in capital usage (capital adequacy limits) to IFIs in using sukuk in different ways. Deducing from the review of the main regulatory documents of Basel I and II, pertaining to Capital Adequacy⁴⁷, the emphasis of the regulators is on making it obligatory for the Financial intermediaries, to have a certain minimum safety level of core equity and (then) supplementary equity as a base and buffer that absorbs shocks from their cycle of creating "assets" out of "debt portfolio". Since the assets created are also a debt –based portfolio, any delay or default in payments due from this "asset portfolio", would put the bank in difficulty

⁴⁷ The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), and The International Convergence of Capital Measurement and Capital Standards report (Basel II) dated June 2004 by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland.

in paying its own obligations to depositors as they fall due⁴⁸. For instance, during a recessionary phase, the chances of many borrowers delaying or defaulting on their payments due will be very high. Primarily the core equity and to some extent the supplementary equity of the bank, would “absorb” as a buffer, such delays and defaults. However, in a recessionary period, if many or majority borrowers default, the 8% core and supplementary equity total is not sufficient to cover the losses. The central banks have to bail out banks, as lenders of last resort.

If the profits, in good times go to the shareholders and the losses in bad periods (like recession, or slump in an economy or a sector) are borne by the central banks and hence the whole country, this is an unfair business.

The regulators are attempting to safeguard the depositors’ money and reduce the shocks to the financial system, through introduction of the “minimum” capital adequacy levels through the adoption of the Capital Adequacy Standards. These are bare minimum levels in an ordinary course of business and not sufficient in times of business cycle downturns, recessions and slump.

2.4 Regulatory Challenge in Islamic Banking and Capital Markets

Just like the initial difficulty in devising Sharia’h permissible yet market compatible Islamic financial products in the Islamic banking industry and the Islamic capital markets, the regulations for these products have been equally challenging. The challenge gets more intense due to the developments in regulations in conventional banking and finance on the

⁴⁸ This discussion is from the point of view of deposit keeping and lending on interest, the main business activity of financial intermediation, developed in the predominantly capitalistic economic system.

one hand and the complexity of the Islamic financial products combined with the pre requisites of the Sharia'h which is a regulation on its own.

On the Sharia'h side, it took a lot of efforts for the learned scholars to describe the Islamic financial products, in liaison with the practitioners and economists in the nascent Islamic financial industry. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is one such example of a concerted effort in this direction, besides others. Its published Sharia'h Standards book, is an exhaustive work on all Islamic financial products and services in the form of a standard for each category. In addition, the Islamic Financial Services Board issues regulations for the Islamic financial Industry, catering to the specific needs of the Islamic financial industry and making efforts to conform to the international financial regulations. Besides, at national level, Muslim countries' Central regulatory authorities are also in the process of devising prudential regulations for the Islamic financial industry.

The current research shall be of immense significance for the Islamic financial regulatory industry in its analysis of sukuk from the AAOIFI Sharia'h standards' as well as International capital adequacy requirements given in Basel II report.

Besides the necessity of meeting the international standards for operations at the worldwide level, compliance with International capital adequacy regulations are extremely important for Islamic Financial Institutions as the financial system must not be fragile or vulnerable to failure. Failure or collapse brings loss to the whole economy and disrepute to the system and products. Due to the deferred payment based outstanding debt, Islamic financial institutions are also exposed to credit risk. Hence the Islamic financial institutions must also meet the international regulatory requirements.

2.5 The Sukuk Market

The current form of sukuk issuance through tapping international markets, started from the year 2001 with the first international corporate issue of Guthrie (a Malaysian corporate sukuk, for US\$ 150 million (mn) of five years' tenure (Mokhtar S., 2007), followed by Malaysian Global sukuk (2002, US \$600mn seven years tenure) and Bahrain's two sovereign sukuk issues (both in 2002, amounting to US \$80 mn and US\$50 mn⁴⁹ respectively). In addition some of the noteworthy issues in the initial period were Qatar Global sovereign (*Ijara'h*) sukuk for US\$700 mn. in 2003, The Islamic Development Bank's (IDB) composite sukuk called Solidarity Trust Services (STS) Sukuk in August 2003 for US\$ 400mn, Pakistan's Global (*Ijara'h*) sukuk in January 2005 for US \$ 600 mn besides sukuk issued locally in Bahrain and Malaysia.

The volume and size of sukuk issues increased over the years. From one or two issues per annum, from 2001 it gained momentum to as much as 89 issues in 2005, 199 in 2006 and 207 sukuk issued in 2007. The volume or value of sukuk was less than \$500 million in 2001, \$10 billion in 2005, about \$25 billion in 2006 and (47.099 billion in 2007 according to Khaleej Times, (2008) and) more than \$60 Billion according to Standards and Poors and Zawya⁵⁰. In the Middle East region alone, 38 issues in 2006 and 53 in 2007 originated⁵¹. In 2007 the region-wise activity was as follows: In UAE alone \$33 Billion worth of sukuk were issued in 2007, followed by Malaysian market⁵², reaching \$25 Billion. The ringgit denominated sukuk in Malaysia surpassed dollar denominated sukuk, whereas most of the GCC sukuk were

⁴⁹ “*Islamic Finance Industry Comes of Age*”,p.5, www.standardandpoors.com

⁵⁰ Standards & Poors, RatingsDirect, March 2008

⁵¹ “*Islamic Finance Industry Comes of Age*”,p.5, www.standardandpoors.com

⁵² ameinfo news (downloaded June 5, 2008)

dollar denominated.⁵³ Malaysia was quoted to have 67% concentration of the total global sukuk issues as of May 2007 (Islamic Financial Services, 2007).

Despite the debut issue of a corporate sukuk (Guthrie) from Malaysia, the initial phase saw sovereign global sukuk issuance from various countries. These were followed by corporate issues. Lately (2007-08) both corporate bodies and financial institutions are predominant in issuing sukuk⁵⁴.

Kuala Lumpur, Bahrain and Dubai are noteworthy areas of concentration regarding sukuk issuance and listings, followed closely by other middle eastern countries like Qatar, Saudi Arabia, and Kuwait. Singapore and London are vying to develop a market position for themselves in sukuk issuance. Bahrain's Liquidity Management Centre is playing a key role of listing medium and long term sukuk as well as short term *salam* sukuk, adding to the liquidity and depth of the sukuk market. The Dubai International Financial Exchange⁵⁵ which started operations in 2002, had listed \$7.6 billion worth of sukuk at year end 2006 and \$16.1 billion at year-end 2007⁵⁶. Trading in Sukuk has also started and there are sukuk indices too. Outside the Muslim countries, noteworthy issues of sukuk included the Germany's State of Saxony-Anhalt's €100 million sukuk in 2004, the recent U.S.-based

⁵³ *ibid.*, Khaleej Times, quoting IFIS, 2008

⁵⁴ . Standard and Poor's Commentary Report 25 October 2006 , published on RatingsDirect, March 2008

⁵⁵ DIFX started operations in 2002 as a financial free trade zone, an on-shore centre with "off-shore" facilities and a tax-free area, with freehold property features, with 100 per cent foreign ownership option available, and no taxation on income or profits generated by firms..

⁵⁶ S&P, reported by Khaleej Times, 2008 , .

companies namely Lehman Holdings Inc. and East Cameron Gas Company's sukuk (worth \$165.67mn in 2007) and Japanese government's initiative to issue sukuk⁵⁷.

Noteworthy sukuk issues

- * *Ist global sukuk : Guthrie (corporate) (2001) for US \$ 150 million. Involved plantation development in Indonesia.*
- * *Malaysian Global sukuk . US\$ 600 million, 2002, debut sovereign sukuk*
- * *US\$ 3.5 Billion Dubai Ports (PCFC Development FZCO sukuk) issue dated 2006... It was the biggest issues at the time of issue.*
- * *The first sukuk listed on London Stock Exchange US\$200 million Tabreed's sukuk (July 2006)*
- * *Caravan I sukuk (2004,Saudi Riyal 102,mn) from Alkaram a complex innovative, two-tiered structure that met Saudi Arabian legal requirements as well as requirements of the investors . It was awarded innovative structure of the year*
- * *WAPDA sukuk (in Pakistan) dated January 5, 2006, for Rs. 8 Bn. Holding WAPDA sukuk qualified as Statutory Liquidity Reserve (SLR) for banks in Pakistan.*
- * *Dubai Islamic Bank's Sukuk issue ,*
- * *Maybank's sukuk (in Malaysia) issue 2007-08 which qualifies as tier II regulatory capital US \$300 million*

2.6 Taqi Usmani -Sukuk and their Contemporary Application, (2008)

While the current research had already culminated in its own way of drawing conclusions from the primary documents of issue vis-à-vis the AAOIFI Sharia'h Standards and the Basel II based securitization framework, It is noteworthy to mention the concern voiced by a renown Sharia'h Scholars, from Pakistan, who is the Chairman of Sharia'h Council of AAOIFI, namely Taqi Usmani (former Justice of the Supreme Court of Pakistan). This concern was re assuring as it went in line with the current research finding. Hence it is included here.

Dr Usmani has pointed out that giving a known, predetermined amount of return and offer price on *Musharakah* and *Mudaraba* sukuk is like a guaranteed return which is contrary to

⁵⁷ Please note that the data in this research is around mid 2008, as it was complete by then and submitted.

the spirit of Islam and against the principle of equitable distribution of wealth. He commented on the current sukuk practices that almost all of the sukuk being issued nowadays guarantee the return to the sukuk holders at maturity, just like conventional bonds. All sukuk being issued nowadays have indirectly guaranteed the principal investment to Sukuk holders. In addition, he added that through the complex sukuk structures the elements of the interest bearing bonds are adopted, as the return to sukuk holders is no more than a fixed amount of return and a guaranteed principal. He also objected to the fact that in many sukuk, transfer of assets from the borrower to the lender did not take place, causing doubt regarding the issue of who is bearing the transaction's risk (Usmani, 2008)⁵⁸.

He further cites some of the benefits of sukuk and gives the following:

He considers Sukuk to be “among the best ways of financing large enterprises that are beyond the ability of a single party to finance”. Similarly, he considers Sukuk to be excellent for investors “seeking to deploy streams of capital and who require, at the same time, the ability to liquidate their positions with ease whenever the need should arise. He foresees development of a secondary market for Sukuk trading where sukuk holders can encash their sukuk . In addition he considers Sukuk investment by banks and Islamic financial institutions to be a very good means of managing their liquidity . Lastly, and very importantly, he considers such Sukuk as enabling equitable wealth distribution, due to the reason that the investors “benefit from the true profits resulting from the enterprise in equal shares. In this way, wealth may circulate on a broad scale without remaining the exclusive domain of a handful of

⁵⁸ Refer to Annex V for clippings of news item

wealthy persons⁵⁹. This is clearly among the most important of all the higher purposes sought by an Islamic economic system”⁶⁰.

⁵⁹ See al-Qur'an at VII:59. YTD

⁶⁰ Usmani Taqi., 2008

Chapter 3

Methodology

3.1 Type of Research

This research consists of exploratory, descriptive and explanatory elements. It consists mostly of archival research. The researcher conducts qualitative comparative analysis based on printed and published secondary literature and data. The units of analysis are the different types of sukuk. The characteristics of Sukuk are evaluated for their compliance with the Shari'a Standards given by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). These are also studied for their economic substance, to assess whether risk transfers from originator to sukuk holders in sukuk securitisation. This is tested, using securitisation framework of Basel II regulatory report by the Basel Committee for Banking Supervision (BCBS, Basel) for the G-20 member countries. The recommendations of the Committee are being adopted initially by the member countries and now by all international financial institutions. They are also incorporated in the national prudential regulations for financial institutions in various countries, including Pakistan. The sukuk structures as represented by their issuance prospectuses are analysed in the light of the Basel II regulatory report. The research findings would enable product assessment and innovation within the International financial regulatory and Sharia'h frameworks.

Content analysis was used in order to present a clear understanding of the Sukuk, and to validate or refute its position from the perspective of Sharia'h as well as the latest conventional international financial regulations. It required qualitative understanding of the Sharia'h guidelines and the international financial regulations. The focus was on form as well

as substance, as both parameters were very important for the in-depth study. This was a time when sukuk were at their nascent stage and little (if any at all) was written about the Sukuk from analytical research point of view. It was making news headlines but from a marketing or news perspective. Sukuk described as “Equity Bonds” may have been a good name from marketing perspective but the term was rather confusing or self-contradictory from the financial point of view. Hence it required an extensive qualitative content analysis, starting right from the issuance prospectuses. The Sharia’ Standards (of AAOIFI, 2004) and the International Regulatory report of Basel II (2004) were the latest and the best benchmarks available to compare with.

There is also another very important element of the “Equity bond” name of the sukuk which links the Sharia’h cum conventional financial regulations in this research. This is explained as follows: The International financial regulations of capital adequacy requirements are encouraging a risk-based equity capital requirement as trading off risk and efficiency through the incentive of reduced equity base when risk is minimized. When a financial product has equity content, as mentioned in the name “equity bond”, that product provides a safety capital buffer by design. This could prove to be a low risk product and hence a very useful product for Financial Institutions. Therefore, with this objective in mind, the kind of research design adopted was necessary.

The research questions which have been stated in the form of hypotheses are :

1. Does Sukuk conform to the Principles of Sharia’h [as stated in the AAOIFI, Sharia’h Standards(2004)?

2. Are AAOIFI defined sukuk based on different securitization techniques than those adopted in conventional securitization?
3. Is risk in Sukuk structures getting transferred from originators to sukuk holders⁶¹?
4. Would risk weighting concessions (of Capital Adequacy Requirements of Basel II's Securitization Framework (2004)) apply to those Islamic Financial Institutions (IFIs) issuing sukuk?

It is important to note that the research questions are formulated as Null Hypotheses and when they are refuted, the alternate explanations explain the alternate hypotheses. Detailed explanations accompany each test.

3.2 The Research Process

This exploratory cum explanatory research bears implications for future course of action. As it touches upon an unusual combination of Sharia'h guidelines and international conventional financial regulations for analyzing the sukuk attributes and scientifically seeking whether or not the sukuk meet the criteria sought after, it involved a lot of reflexive thinking leading towards internalizing of the concepts, drawing qualitative inferences.

For a thorough grasp of the sukuk, numerous sukuk issuance prospectuses were analysed as they were being issued and as they were available. These are legal documents, each custom-made according to the needs of the originators and meeting the target market investors'

⁶¹ According to the Sharia'h risk gets transferred in a sale of assets or usage. In derivative structures, risk gets transformed and/or sold (& hence transferred) from one entity (originator) to another (guarantor or investor or both/and others), in the securitization process

expectations. Each document spans approximately 180 to 300 legal sized pages on average. This activity provided the base for understanding each sukuk pattern. It enabled identification of repeat or similar patterns as well as some unique or complicated product designs. Based on this analysis, the two sample sukuk were chosen for their use in the comparative study with AAOIFI Sharia'h Standards, regarding Hypothesis I and sukuk securitization in Hypothesis II. Some of the noteworthy sukuk prospectuses that were analysed, are mentioned below:

- a. Solidarity Trust Services Sukuk (2003),
- b. the Qatar Global Sukuk 2003,
- c. The Malaysian Global Sukuk 2003,
- d. The Bahrain Global Sukuk 2003,
- e. The Pakistan International Sukuk Company Sukuk 2005,
- f. The WAPDA Sukuk 2006,
- g. The PCFC Sukuk 2006,
- h. The Nakheel Sukuk 2007,
- i. The Caravan I Sukuk 2004

There are many types of sukuk, based on their underlying structures, according to the Sharia'h Standards for Investment Sukuk issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2004). With the ongoing analysis of the sukuk structures from the sukuk prospectuses, it was observed that the Ijara'h sukuk were a pre-dominant category. In addition, it was observed that the Ijara'h sukuk, except for the different underlying assets of each individual sukuk, were almost replicating themselves.

It was possible to pick a representative sample. for testing of attributes of Ijara'h Sukuk. The local currency sukuk originated in Pakistan, namely the WAPDA sukuk was chosen to represent the Ijara'h sukuk category. During the course of the research, a new type of sukuk, belonging to the Musharakah sukuk category was floated. It created news waves in the Islamic Financial circles for the brevity to launch the first equity participation-based sukuk, besides other factors like the sheer volume of the issue and the nature of the underlying transaction and the originator. This sukuk, namely the PCFC Sukuk, was also the first sukuk with a two-tiered structure, providing the sukuk's conversion into equity shares. Hence it had all the reasons to be chosen for study. For delving into the prospects of sukuk for Islamic Financial Institutions, the only available choice (in 2005) was the STS Sukuk (2003) which was a composite sukuk and issued by the Islamic Development Bank, which is one of the elite group of International developmental bodies with zero credit risk according to International regulatory bodies and rating agencies. Its analysis was quite useful in terms of testing Hypotheses III and IV of the research, which in turn provided further insights on the economic substance of the sukuk contracts designed and the issue of risk weighting concessions for IFIs.

For testing Hypothesis I, the Sharia'h based guidelines on Islamic financial contracts issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), namely the AAOIFI Sharia'h Standards (1424-5H/2003-4) were studied and consulted in comparison with the two sukuk types (Ijara'h sukuk and Musharakah sukuk) which were chosen for analysis. The AAOIFI Sharia'h Standards are published as a book by the AAOIFI. They provided the yardstick for assessing the Sukuk. These Sharia'h Standards have defined sukuk as Investment sukuk in the Sharia'h Standard No. 17. Their types and specifications

are given. However, they have not given any generic sukuk contract structure (like the prospectus) to follow as yet.

Hypothesis II assesses the position of sukuk as securitization instruments in a Sharia'h prescribed framework. It further compares them with conventional securitization properties, in order to prove or falsify any similarities and /or differences between them. A case -study like approach describes the properties of an AAOIFI subscribed sukuk, the Sukuk in practice, and the conventional securitization. In the process, it also explains at length to what extent and in what shape, the sukuk can be helpful in securitizing the real assets and usufruct rights in Islamic Financial Institutions.

For testing Hypothesis III an IV, along with the qualitative analysis of the STS Sukuk (2003) as a sample to test, it was pertinent to study the International regulatory reports for capital adequacy guidelines in the conventional banking setup. The capital adequacy guidelines were chosen because the financial institutions are always trying to manage their businesses with minimum possible capital limits , as compared to their time and demand liabilities (their business volume) while the financial regulators try to subscribe minimum capital levels for the banks for the sake of financial stability and safeguarding the depositors' money. If sukuk deem to be equity based as their name of equity bonds point out, then they should open an avenue for the Islamic Financial institutions to utilize positively for meeting their funding needs through sukuk securitisation as well as complimenting their capital adequacy requirements in the process, because of their equity content. However, the task cannot be performed without knowing the details of the relevant current regulations on capital adequacy assessment for subscribing minimum capital limits for financial products. Besides, this exercise is mainly in futuristic perspective as no Islamic Financial Institutions, other than

the developmental Financial Institution, namely Islamic Development Bank (IsDB) had issued any sukuk at that point in time (in 2005). Hence the IsDB's sukuk, namely the Solidarity Trust Services (STS) (2003 issue) sukuk was chosen for comparison with conventional securitisation in order to draw parallels before analyzing it from regulatory perspective. This Sukuk's study preliminary study also revealed the presence of a securitisation pattern in the structure of the sukuk.

The Basel I report is the common name for The International Convergence of Capital Measurement and Capital Standards report dated July 1988 issued by the Basel Committee on Banking Supervision (BCBS). The Basel II report means the International Convergence of Capital Measurement and Capital Standards report, dated June 2004. It is also issued by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland. These documents were obtained through mail from the Bank of International Settlements (BIS), Basel Switzerland. The Basel I and II reports were scrutinized before formally drawing and redrawing Hypotheses III and IV.

The phenomenon of interest remained the sukuk and the quest for their unique attributes (if any) causing them to be practiced by the Islamic financial markets with investment interest from Muslim as well as non-Muslims and conventional investors. Sukuk being termed as equity bonds were strange enough to stir the curiosity culminating in the thesis.

Some of the points that were revealed during the Literature review stage were the following:

If Islamic financial instruments were to be tradable and profit or revenue generating instruments they would be governed by the Sharia'h principles of profit and loss sharing and revenue sharing among the stakeholders. There can be Islamic debt-based instruments but they can't be traded at any value other than par. (Khan T., Iqbal M., Ahmed A., 1998). It led

to the query that if sukuk are called equity bonds and if bonds are debt instruments, how do we define sukuk and what are their attributes? Hence this required the study of the sukuk prospectuses which are the core legal documents accompanying the sukuk issue. They are available with the issuing authorities and with those who subscribe to it, besides the national financial and economic authorities of governments.

To see the Sharia'h ruling or guidelines on the Islamic Financial contracts including sukuk, the AAOIFI Sharia'h Standards (1424-5H/2003-4) published by the Accounting and Auditing Organization for Islamic Financial Institutions, Manama, Bahrain, serves as the benchmark with international acclaim. These standards were reviewed. By analyzing the relevant clauses and sections of the AAOIFI Sharia'h Standards, and some of the sukuk prospectuses, which included the Solidarity Trust Services Sukuk , the Qatar Global Sukuk ,2003, The Malaysian Global Sukuk 2003, The Bahrain Global Sukuk 2003, it was observed that the AAOIFI provides the broad definitions and underlying principles, while the prospectuses have designed sukuk practically using clauses and wordings that are comparable to the clauses and features in International bond prospectuses. This aspect caused the need for double checking the sukuk as given in the prospectuses with the AAOIFI guidelines for the sukuk as well as the Basel II report for ascertaining their economic substance.

Based on the nature of business activities of IFIs, it was expected that in the near future, sukuk shall be used by IFIs for Islamically permissible securitisation and fund generation. Product usage by IFIs is subject to regulatory requirements of the financial intermediation industry. Currently, risk-based capital adequacy regulations are applied to national and International financial institutions including IFIs. The source of capital adequacy regulations

are the Basel I and II documents discussed earlier. The most relevant updated version of these regulations is Basel II. Hence Basel I and II documents were studied and the sukuk scrutinized for the core risk transformation attribute. The securitisation framework of credit risk (Pillar 1) of Basel II was specifically used for the IFIs sukuk. The specific traits studied were discussed earlier.

The Basel I and II regulatory requirements for financial institutions:

Basel I is the common name assigned to the International Convergence of Capital Measurement and Capital Standards report dated July 1988 by the Basel Committee on Banking Supervision (BCBS). Similarly, Basel II is the popular name for The International Convergence of Capital Measurement and Capital Standards report, dated June 2004 by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland. The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Deducing from the review of the main regulatory documents of Basel I and II, pertaining to Capital Adequacy⁶², the emphasis of the regulators is on making it obligatory for the

⁶² The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), and The International Convergence of Capital Measurement and Capital Standards report (Basel II) dated June 2004 by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland.

Financial intermediaries, to have a certain minimum safety level of core equity and (then) supplementary equity as a base and buffer that absorbs shocks from their cycle of creating “assets” out of “debt portfolio”. Since the assets created are also a debt –based portfolio, any delay or default in payments due from this “asset portfolio”, would put the bank in difficulty in paying its own obligations to depositors as they fall due⁶³.

Basel II looks beyond the products’ types or names and tries to assess⁷ their economic substance. It looks at the products’ credit risk, following the conventional system of giving return and bearing loss among the parties to the exchange. From the point of view of assessing the risk weighted capital adequacy requirements for the products, the parameters of assessment are:

Who owns the assets, who bear the risk in returns and to what extent? In this regard, what measures are in place to mitigate risk and how effective they are?

Hence the study of Basel I and then Basel II reports showed that these documents were discussing financial products primarily from their debt or leverage –based system of pre-determined returns without sharing of risk in conventional lending- borrowings and bonds. Secondly, the emergence of derivatives and structured finance products were causing distortions and camouflaging regarding risk shifting, in a manner that it was important to know which stakeholder is actually bearing risk and to what extent. This was taken up by Basel II, which was stressing on understanding the economic substance of the products or transactions and assigning capital adequacy requirements to the products and institutions

⁶³ This discussion is from the point of view of deposit keeping and lending on interest, the main business activity of financial intermediation, developed in the predominantly capitalistic economic system.

according to the extent of risk borne or transferred from the originator to others. It was felt that the study of Basel II in its ability to bring out the economic substance of the sukuk and therefore analyzing their risk transforming ability would benefit in getting a clear view of the sukuk, although there can be a possibility that Basel II, may stop short of being able to assess the Islamic Financial products, due to any unique attributes not present in the leverage promoting and debt- based products and system of conventional finance.

To sum up, besides the citations and references cited in the bibliography, the following documents were the main research documents consulted:

1. The AAOIFI Sharia'h Standards (1424-5H/2003-4) AAOIFI, Manama, Bahrain.
2. The Basel I report: The International Convergence of Capital Measurement and Capital Standards report dated July 1988 by the Basel Committee on Banking Supervision (BCBS).
3. The Basel II report: The International Convergence of Capital Measurement and Capital Standards report, dated June 2004 by the Basel Committee on Banking Supervision (BCBS), Bank of International Settlements (BIS) Switzerland.
4. The sukuk prospectuses (pertinent ones mentioned as follows) :
 - a. Solidarity Trust Services Sukuk (2003),
 - b. the Qatar Global Sukuk 2003,
 - c. The Malaysian Global Sukuk 2003,
 - d. The Bahrain Global Sukuk 2003,
 - e. The Pakistan International Sukuk Company Sukuk 2005,
 - f. The WAPDA Sukuk 2006,
 - g. The PCFC Sukuk 2006,

- h. The Nakheel Sukuk 2007
- i. The Caravan I Sukuk 2004

3.2.1 The process of acquiring the secondary data and documents along with the progress in research

These documents were mostly obtained from scholars and notable people in the Islamic Economic Research field outside the country. In this process, three notable institutions within the country were contacted for obtaining the first global sukuk issue that was issued by the Pakistani Authorities (namely the Pakistan International Sukuk Company sukuk). However, interestingly, the document was considered as sacred and confidential and hence not provided. At last, the draft of that too was obtained from an international Islamic Research authority upon request, and the relevant people in the Securities and Exchange Commission of Pakistan were requested through personal contacts to fill in the relevant data in it. The contract structure was very close to the Qatar Global sukuk that was issued earlier and was available with me. The Ministry of Finance was approached through appointments and visits to their relevant Section Officers and finally the Advisor Ministry of Finance. The Section Officer was helpful and hospitable and did call relevant person from the bank that was liaising with the ministry on the issue. Besides only revealing the difficulties faced in practically doing the Asset-based transactions, in the rural jurisdictions regarding the motorway development projects, the data regarding the financial cash flows regarding the sukuk were not discussed or given and avoided. Hence, it did not make any contribution in getting an insight on how and why the financial structure was put in place. The relevant authorities including the Head of the State Bank, Islamic Banking Division were personally met and request for relevant information emailed to them but they never replied. It was an

extremely disappointing phase in the first year 2005, as well as subsequently, regarding the lack of interest shown in Pakistan in sharing information, let alone guidance from the relevant people in the practical field.

In the meanwhile, the Basel I and II documents were obtained from the Bank for International Settlement, Basel, through their website as well as through email. The documents were promptly mailed to me, free of cost. These documents were studied and summarized. The background build through the MS in International Banking and Financial Studies, from the University of Southampton, U.K apparently helped me in understanding and deciphering the regulations. In addition, my previous professor (Professor George McKenzie)⁶⁴ gave some brief but pertinent pointers for the study which have been very useful in the direction of the research. The first breakthrough in the study came in the form of acceptance of my research paper's abstract in an international call for papers in the same field of Islamic banking regulations from Islamic Research and Training Institution, (IRTI) Jeddah in October 2005. It established a very useful link with the senior researchers of IRT. This was the real live link through the internet, which supported me throughout the years of research, whether it was request for any secondary material or a query. The first conference also enabled me to discuss my findings with the renowned researchers and getting assured for the first time regarding the direction of the research and the research findings. It also provided me a network and a platform of discussion although the study was very new, at a nascent stage and very little was known about the sukuk.

⁶⁴ Now retired from The University Of Southampton, U.K

Throughout the years, whenever the news of sukuk arrived, hectic search was made for obtaining them , especially the Pakistani sukuk or similar products (TFC⁶⁵), in which most of them were privately placed through the banks based in Pakistan, but in vain. It is to be noted that Pakistan issued a large number of privately placed sukuk, mostly in the years 2006-2007. The documents could not be obtained from the banks as well as the SECP, State Bank of Pakistan and NIBAF in Islamabad. They kept things pending and finally showed their inability to provide the documents. Hence the search was abandoned, and these products' study was not included. It were the sukuk obtained from people in International Islamic financial Institutions, which provided me the material on International sukuk issues.

The AAOIFI Sharia'h Standards (1424H/2003-4) published by the Accounting and Auditing Organization for Islamic Financial Institutions based in Manama, Bahrain has been an important point of reference in deciphering the newly emerging sukuk market. Another point of interest was the emergence of "Musharakah Sukuk" where the AAOIFI Sharia Standards were a great help, after obtaining the Sukuk prospectuses. The results obtained from the comparative analysis of these sukuk were difficult to discuss with anyone as no literature existed on it. Another call for papers, again from IRTI in 2007 and acceptance of our research paper (with my senior colleague, and economist, Dr. Memoona R Khan), was the other main breakthrough in the research. It enabled me/us to discuss our apprehensions regarding the asset-backed sukuk in general and the Musharakah sukuk in particular. This conference paper (Islamic Capital Markets, Jakarta, 2007) is was later published by IRTI in

⁶⁵ TFC stands for Term Finance Certificates. These are redeemable capital securities, offering expected profit rates, instead of interest rate to subscribers. They are corporate debt securities, which were initiated in 1984-5 in Pakistan.

a book form in 2008, by the name Islamic Capital Markets, edited by Syed Salman Ahmed and is available at their website too. Another important research paper was presented with my Research Advisor, (Dr. Tariq Javed) during the International Conference by Pakistan Institute of Development Economics and later published in their Journal in 2008. Hence the research findings and analyses were discussed during International conferences. The research produced five conference papers presented by the researcher at International research conferences and two International Research papers. Another research paper, sent in 2007 to Islamic Research and Training Institute, Islamic Development Bank, Jeddah is now in the process of publication in their Journal, Islamic Economic Studies, shortly.

3.3 Research Hypotheses- Tabular form

Testing Hypothesis I

Hypothesis I: Sukuk conform to the principles of Sharia'h

		Hypothesis No.1	
		AAOIFI Sharia standards' compliant	
Sukuk structures	characteristics		Comments/Inference
Ijara'h Sukuk			
	The underlying asset		
	The contract of Ijarah		
	Distribution mechanism		
	Return distribution		
	With originator		
	With SPV		
	With sukuk holders		
	Loss/distribution		

	With originator		
	With SPV		
	With sukuk holders		
	Guarantees		
	Repurchase Agreement		
Musharakah Sukuk			
	The underlying assets		
	The contract of Musharakah		
	Distribution mechanism		
	Return distribution		
	With originator		
	With SPV		
	With sukuk holders		
	Guarantees		
	Re-purchase Agreement		

Hypothesis II:

“Sukuk are based on different securitization principles than that adopted in conventional instruments”

Testing Hypothesis II

Comparing AAOIFI's Sukuk and Conventional securitization				
		AAOIFI Ijara'h Sukuk	AAOIFI Musharakah Sukuk	Conventional securitization
1.	Asset-backed	Yes/No.	Yes/No.	Yes/No.
2.	Money/debt as asset			
3.	Debt can be sold at a discount			
4.	Credit can be securitized			
5.	Credit tranching			
6	Improves balance sheet efficiency			

Hypothesis III: In Sukuk , risk is transferred from originators to sukuk holders, which is Sharia'h compatible

Hypothesis IV: Risk weighting concessions (of CAR of Basel II) apply to sukuk originating IFIs.

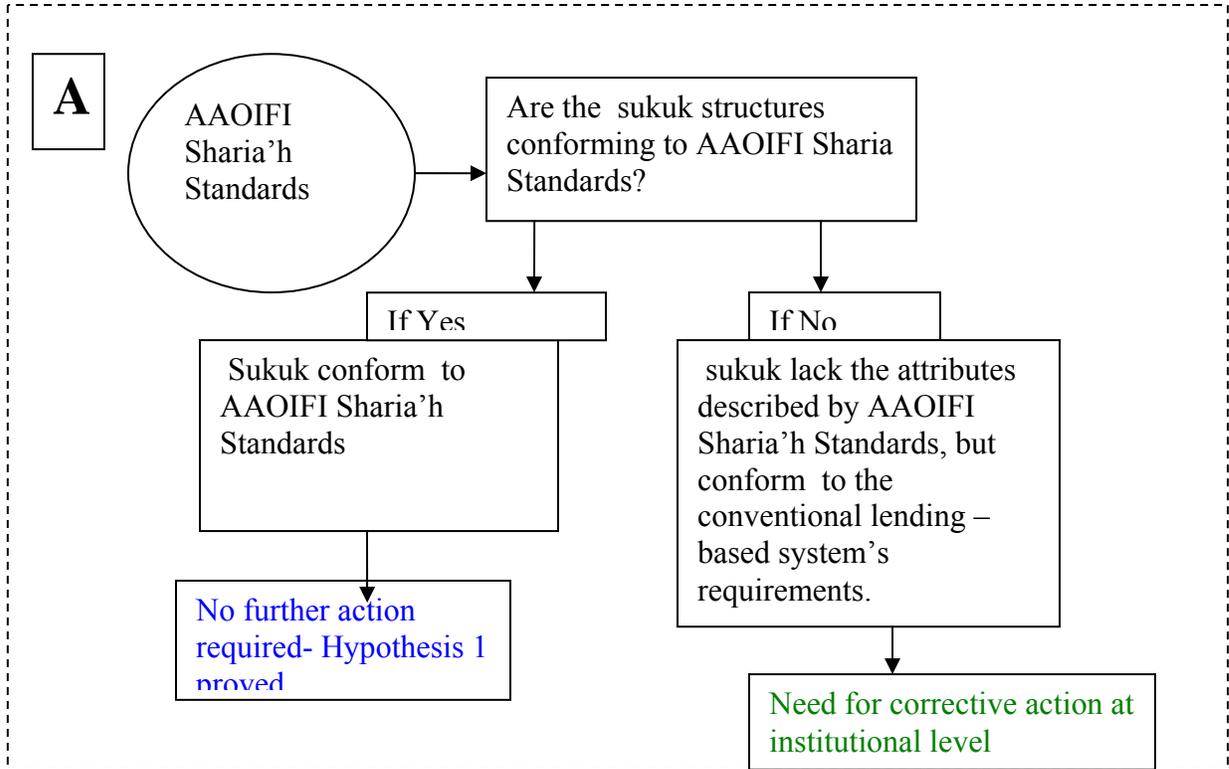
Testing Hypothesis III and IV

		Hypothesis III	Hypothesis IV	
		Excluding sukuk securitised assets from risk –weighted assets	Risk transfer from originator to sukuk holders	
Sukuk structure	Characteristics			Comments/ Inference
STS Sukuk				
	Economic substance			
1.	Significant Risk transfer from IFI (originator) to third party			
2	No effective control of the transferor or its creditors on securitised assets			
3.	Issued Securities not obligation of transferor			
4.	Other clauses (SPE/SPV As Transferee – Amortization plan, clean –up call.			
5.	Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and			

	maturity value of the financial contracts.			
6	Repurchase agreement to mitigate the risk of payment of principal.			
7.	The value or worth of any collateral in terms of market value			
8	omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality			
9.	Any calls or put options embedded in the contract			

Figure 3.5

The Research Process Flowchart

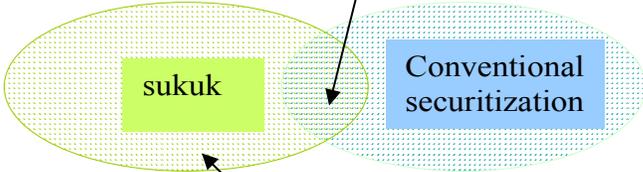


B

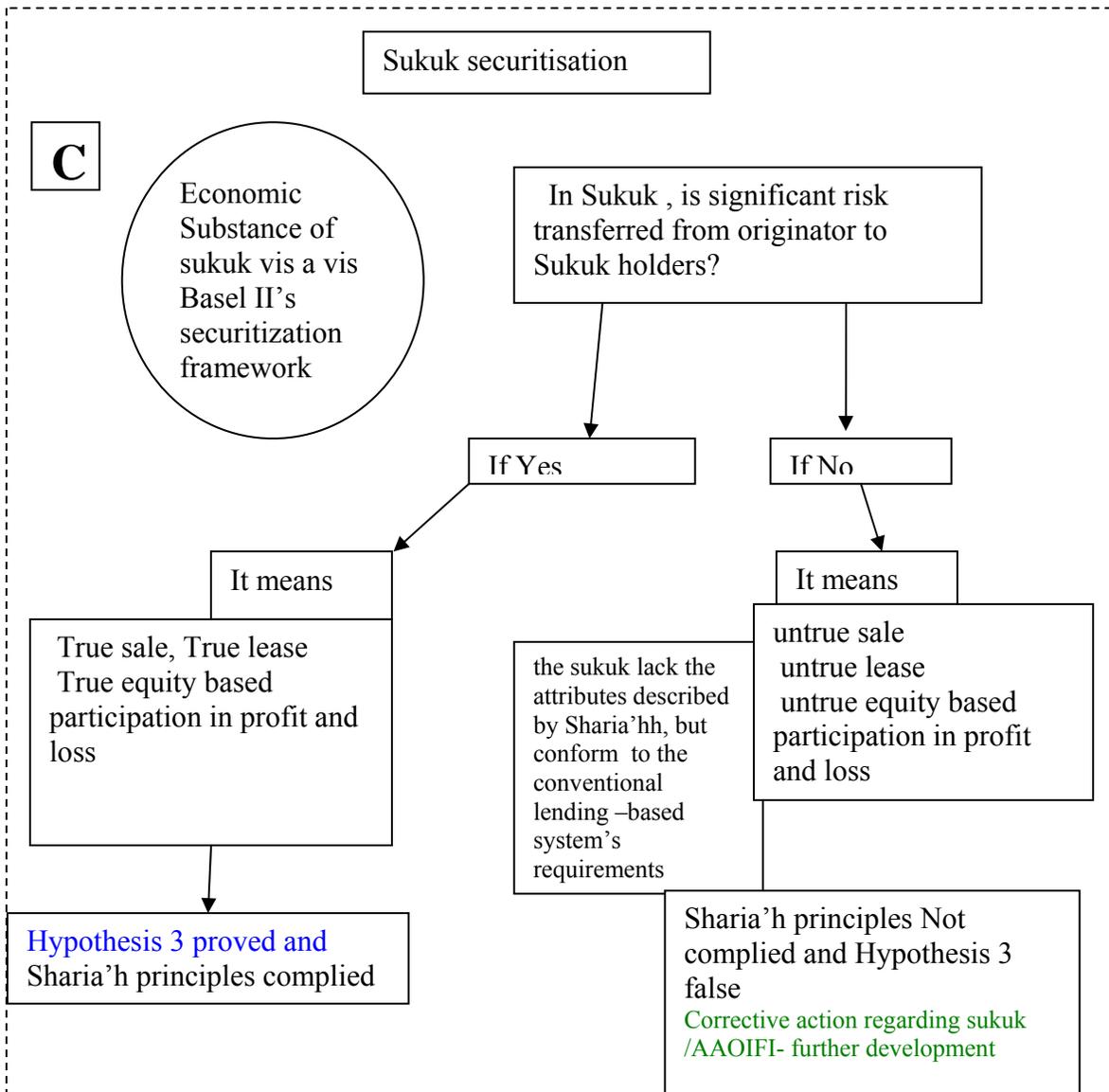
AAOIFI's
sukuk as
securitization
instruments

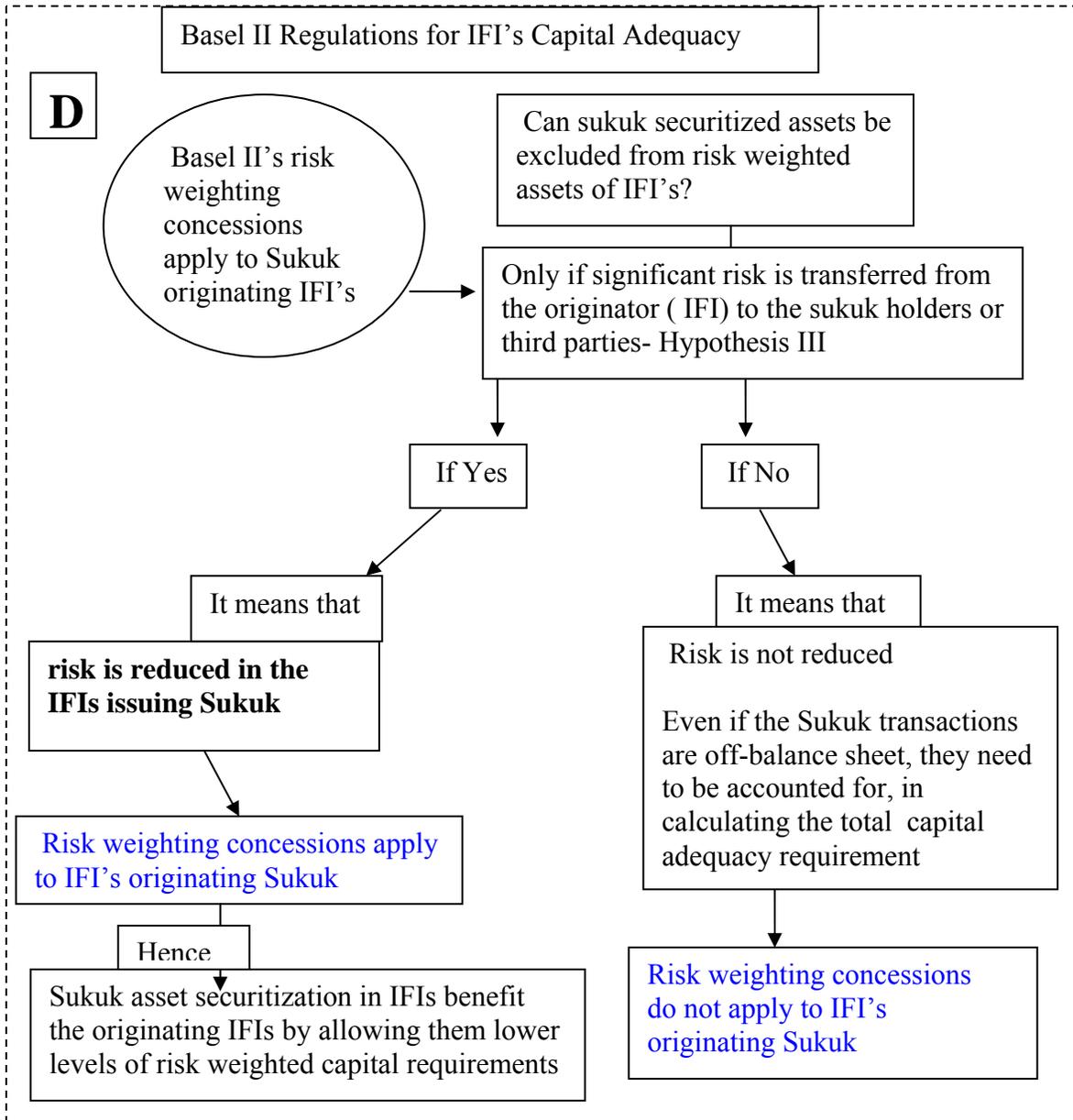
Are sukuk like conventional
securitization?

Any or all overlaps?



Any unique features, due to Sharia'h principles?





Chapter 4

ANALYSIS

Note: This analysis is subdivided into four parts; Section 1 comprises the analysis of sukuk in relation to the sukuk prospectuses. Section 2 analyses sukuk in comparison to the AAOIFI Sharia'h Standards. Section 3 compares AAOIFI's sukuk securitisation process with conventional securitisation and finally section four analyses sukuk in terms of securitisation framework of Basel II.

4.1 Introduction

The analysis of our phenomenon of interest, i.e. the sukuk is a step by step approach, beginning with the detailed qualitative cross-sectional analysis of a number of sukuk issue prospectuses. Common representative types are picked for analysis. The sukuk prospectuses are legal documents, each describing custom-made sukuk contracts, which are a combination of underlying contracts and their clauses. Each prospectus spans approximately 200 or more legal sized pages on average. The sukuk features culled from the sukuk prospectuses, are analysed in comparison with the AAOIFI Sharia'h Standards for compliance. This is the essence of Hypothesis I.

In the next step of analysis, the generic sukuk structures for Ijarah and Musharakah sukuk prescribed in AAOIFI's Sharia'h Standards are compared with conventional securitisation. This is further accentuated by a futuristic case study approach adopted, using a simplified balance sheet of a financial institution and explaining the two securitizations in the context of the balance sheet. Parallels between the AAOIFI's sukuk and conventional securitization are drawn in order to have a very clear view of the sukuk, in how they resemble or differ from

conventional securitisation. It is essential to do this exercise, in order to refute or establish the position of sukuk as securitization products with their distinct Sharia'h based attributes. This is the essence of Hypothesis II.

Hypothesis III deals with assessment of sukuk from the perspective of Basel II regulatory framework. After having established or refuted the statement of Hypothesis II for sukuk as securitisation products (in Hypothesis II), it is to be seen whether the practical sukuk securitization contracts taken as a whole, transfer risk from the originator to the sukuk holders. As a by-product of the hypothesis, it should reiterate or refute the position of sukuk for their compliance with Sharia'h principles for sale, ijara'h, musharakah etc. The Securitisation Framework within the Credit Risk Assessment of Basel II Regulatory Report (2004), for Capital Adequacy Requirements is specifically employed in testing Hypothesis III. This result shall compliment the earlier result of Hypothesis I, in figuring out the effect of the given sukuk structures, their compatibility to Sharia'h and their utility in Islamic Financial Industry.

Hypothesis IV's tests give a clear answer to whether or not risk weighting concessions would apply to the Islamic Financial Institutions (IFIs) issuing sukuk. This is derived from the results of Hypothesis III, which uses the clauses of the securitisation framework of the Basel II regulatory Report (2004), for capital adequacy requirements. In fact Hypothesis IV is based on the result of Hypothesis III. If IFIs risk get transferred or reduced in issuing sukuk, they would be candidates for risk-weighted concession to capital. If risk is not reduced or transferred and remains with the IFI, no risk weighted concessions shall apply to the IFI and sukuk issuance would not benefit in minimizing capital adequacy requirement.

All four hypotheses shall be effective in finding out from the features of the sukuk structures, their compatibility to Sharia, their securitization potential, their risk transfer abilities and the resultant benefit of risk weighted concessions for minimum capital requirements of IFIs issuing sukuk, according to the terms of Basel II securitisation framework.

SECTION 1

4.2 Innovations in Sukuk structures - Qualitative Cross-sectional Analysis

Sukuk are asset-backed financial instruments, complying with the Sharia'h principles following the basic rules of negotiability of Islamic financial instruments (as explained earlier). More specifically, they entail financing and sharing of risk and return related to identifiable, tangible underlying assets, usufructs and projects. Sukuk are issued in the form of scrips and raise funds through subscription to the sukuk. There are many types of sukuk. Some call them as equity bonds or Sharia'h-compliant bonds. They are even labeled as Islamic debt markets instruments, perhaps, because of their underlying structures and for tapping conventional bond market investors besides attracting investors with an inclination towards Islamic principles. Those Sukuk which are based entirely on the principles of profit and loss sharing its returns related to the actual profit and loss from the underlying activities, are not replicating bonds and can be termed as non-permanent equity. In Islamic finance, sukuk are used for funding purposes by sovereigns, corporate bodies as well as financial institutions.

In practice, the sukuk comprise a predominant majority of *Ijara'h* based sukuk with fixed or floating rates of return, being benchmarked mostly to money market indicators like LIBOR (for International market sukuk issues) and their local counterparts (for local currency denominated sukuk). Other types used include *Musharakah* sukuk with fixed rate of return and composite sukuk, consisting of a combination of assets, with the predominant one being

the Ijara'h component. A structuring innovation among sukuk includes medium term two-tiered sukuk with the option to convert to shares upon Initial Public Offering (IPO).

Ijara'h sukuk are the most common type of sukuk issued. They are based on an underlying contract of Ijara'h, or more appropriately, a combination called Sale and lease-back. There are composite sukuk too which have a mix of different types of underlying assets, but a necessary predominant (51%) portion of Ijara'h underlying contracts that make the sukuk permissible. These also follow a sale and lease back structure. Such examples include the Solidarity Trust Services (STS) Sukuk (2003), besides other examples. Some sukuk structures became prominent because of further innovations and uniqueness in their structures. They include the Musharakah sukuk, which were two- stepped, leading towards conversion to shares' option, e.g. the PCFC sukuk, the securitisation sukuk with intricate loops to deal with legal restrictions. e.g. the Caravan I sukuk (2004). A detailed account of some of the sukuk issued is given below by analyzing their prospectuses.

4.2.1 The WAPDA Sukuk- an Ijara'h Sukuk Sample:

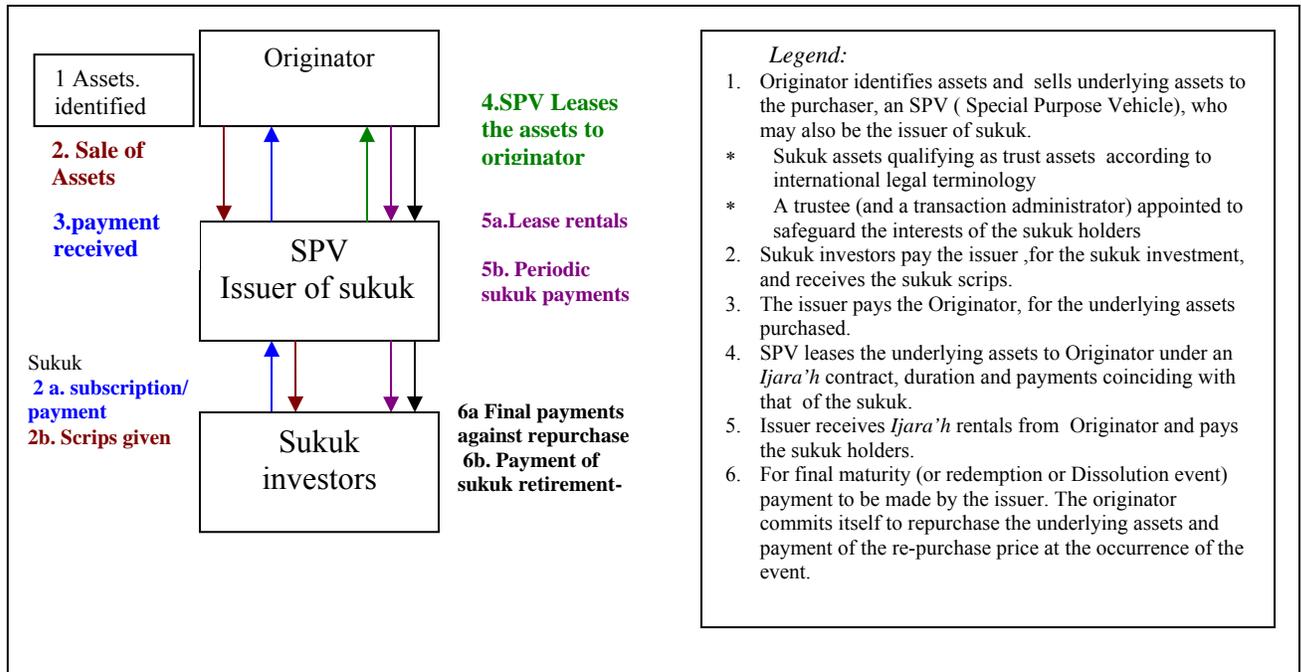
In order to get a clear view of the Ijara'h Sukuk modalities in practice, the WAPDA sukuk is picked here as a representative example. This is a representative sample of the local and global Ijara'h sukuk since the main pattern of individual Ijara'h sukuk are mostly alike. WAPDA Sukuk is a local currency Pakistani Rupee sukuk, based on the principle of *Ijara'h*, (closing date January 05, 2006, due 2013) floated in Pakistan. The issue size was Pakistani

Rupee (PKR) 8.0 billion, with tenure of seven years and was priced at six month KIBOR⁶⁶ plus 35 basis points. The Water and Power Development Authority (WAPDA) of Pakistan, is an autonomous body. It is the sole supplier and distributor of power to the country. The *Ijara'h* Sukuk floatation took place through a specifically set-up Special Purpose Vehicle namely WAPDA First Sukuk Company. The underlying assets comprised ten hydel power generating turbines of Mangla Hydel Power Station. These assets were sold to WAPDA's SPV under Sale and Lease back arrangement for a period of seven years, corresponding to the life the of the *Ijara'h* Sukuk. The project was meant to improve the existing capacity of the Mangla Dam. The issue was further facilitated through a guarantee from the Government of Pakistan, regarding its payment of returns and maturity value to the sukuk holders. The additional feature in the WAPDA sukuk, which is not common in other global sukuk, is the government's incentive policy allowing banks' investment in the Sukuk to qualify as part of Statutory Liquidity Reserve Requirement (SLR) in Pakistan, encouraging Banks to invest in the Sukuk for SLR requirement. However, this incentive has no effect on the sukuk contract structure.

⁶⁶ KIBOR represents Karachi Interbank Offer Rate, a local money market rate, which is used as a benchmark rate in this case.

Figure 4.1

Ijara'h Sukuk's Basic Structure



Source: Author's own

While reviewing various sukuk prospectuses of sukuk based on the principles of Ijara'h , tow points were noteworthy. First, that a sort of common pattern of the sukuk contract based on the sale and lease-back contract was see among all of them. Second, their pricing followed a pattern too reflecting the exposure of sukuk holders on the originator in each case. Hence, sovereign sukuk of similar structures had rates of return according to their sovereign risk factors (sovereign ratings internationally). Therefore, a return of LIBOR plus 0.95 for Malaysian Global (*Ijara'h*) sukuk (2002), LIBOR plus 0.5 for Qatar's Global (*Ijara'h*) Sukuk (2003) and LIBOR plus 2.2 for Pakistan's Global (*Ijara'h*) Sukuk (2005) was noted. All the Ijara'h sukuk were designed like fixed income securities, carrying a fixed pre-determined rate of return , due to the Ijara'h rent factor, implying that the underlying assets , owned by

the sukuk holders were rented out (as Ijara'h contracts) to the lessees , who were the same originators who owned the assets originally, who sold the assets through their SPVs to the sukuk holders, and who would re-purchase the same underlying assets , when the Ijara'h contracts close and the sukuk get retired, in normal circumstances. All the originators or their parent bodies, like the government in case of autonomous bodies as originators, guaranteed the returns to the sukuk holders and undertook the purchase of the underlying assets at pre agreed price , (the sukuk maturity value) , upon expiry of the sukuk tenure.

4.2.2 The PCFC sukuk -A Musharakah Sukuk Example

The **PCFC Development FZCO sukuk** of Dubai (Jebel Ali Free Zone) jurisdiction is selected as an example of a *Musharakah* based structure of sukuk or Musharakah sukuk. This sukuk amounted to U.S.\$3.5 Billion worth of Trust Certificates Sukuk due 2008 (issued at 100 %of the aggregate principal amount of certificates). The Certificates were constituted by a declaration of trust on the closing date (i.e.23rd January 2006) made by the Issuer (SPV) and Ports, Customs & Free Zone Corporation (PCFC). Each certificate (suk) represented an undivided beneficial ownership of Trust assets and ranks pari passu with the other certificates. According to the Musharakah Agreement between the Issuer (SPV) and the obligor (originator), the capital of the *Musharakah* is US\$5 Billion, of which the Issuer contributed US\$3.5 Billion and the originator, namely Ports, Customs and Free Zone Corporation (PCFC) ⁶⁷ made a contribution in kind⁶⁸ of U.S.\$1.5 Billion while the issue price of the sukuk Trust Certificates is U.S.\$3.5 Billion. PCFC is also the Managing Agent of the

⁶⁷ It is a Public Limited Company of the Dubai Ports Authority, Jebel Ali Free Zone Authority and Department of Customs.

⁶⁸ It consists of vesting into the Musharaka , of all of its rights , benefits and entitlement to PCFC usufruct rights.

Musharaka assets and activities. The sukuk holders are paid as follows on the Qualifying Public offering (QPO) and /or redemption date occurrences, whichever the case may be. (a) If a Qualifying Public Offering (QPO) redemption takes place, sukuk holders shall be paid a fixed return of 7.125 per cent per annum of the issue price and (b) If a final or mandatory redemption takes place , a fixed return of 10.125 per cent per annum shall be paid to them. According to the Musharaka agreement between the Obligor (originator, PCFC) and the issuer (SPV), the Musharaka profit distribution shall be 30% to the Obligor and 70% to the issuer (SPV) of sukuk. If the accumulation profit of Musharaka is greater than the return paid and/or settled on redemption of the certificates, such excess accumulated profit count as the Musharaka Management incentive fees of the Managing Agent. Issuer will act as trustee of the trust assets on behalf of the certificate-holders (sukuk holders). An innovative feature of the sukuk from the perspective of sukuk holders is that the sukuk were certificates of partnership and sukuk holders as partners in the profit and loss of the underlying Musharaka, according to their predetermined profit and loss sharing ratio, like any other equity partnership contract. Here we can say that the sukuk was used as a step before the IPO. Certificate holders are also given the choice of receiving the Qualifying Public Offering (QPO) Shares upon application for it, in the case of QPO Redemption. This *Musharakah* arrangement helped finance the takeover of the P & O Ports worldwide interests by the Dubai Ports Authority.

The PCFC Sukuk structure- Basic data at a glance

Issue Size= US \$ 3,5 Billion

Issue date = 23 January 2006

Maturity 2008

Issuer =SPV

Trustee=The Issuer SPV is the trustee of the trust assets on behalf of sukuk holders

Originator= Ports , Customs & Free Zone Corporation (PCFC)SPV

Capital of the Musharaka= US\$ 5 billion

Contribution in kind by originator(PCFC)=US\$1.5 Billion (30% of total)

Contribution by Issuer SPV (PCFC SPV) =US\$ 3.5 Billion (70% of total)

Musharakah Agreement between Obligor (originator i.e. PCFC) and Issuer SPV

The Musharakah profit shall be distributed among the Obligor and the Issuer in the ratio of 30:70 respectively. (according to the capital contribution.)

Managing agent of the Musharakah assets and activities= The originator (PCFC)

If accumulation profit of Musharakah (to be paid to sukuk holders) is greater than the return paid to the sukuk holders upon redemption of the certificates, the remaining balance should count as Musharakah Management Incentive fee of the Obligor and paid to the Obligor.

If Payment to be made to sukuk holders on Qualifying Public Offering date and /or

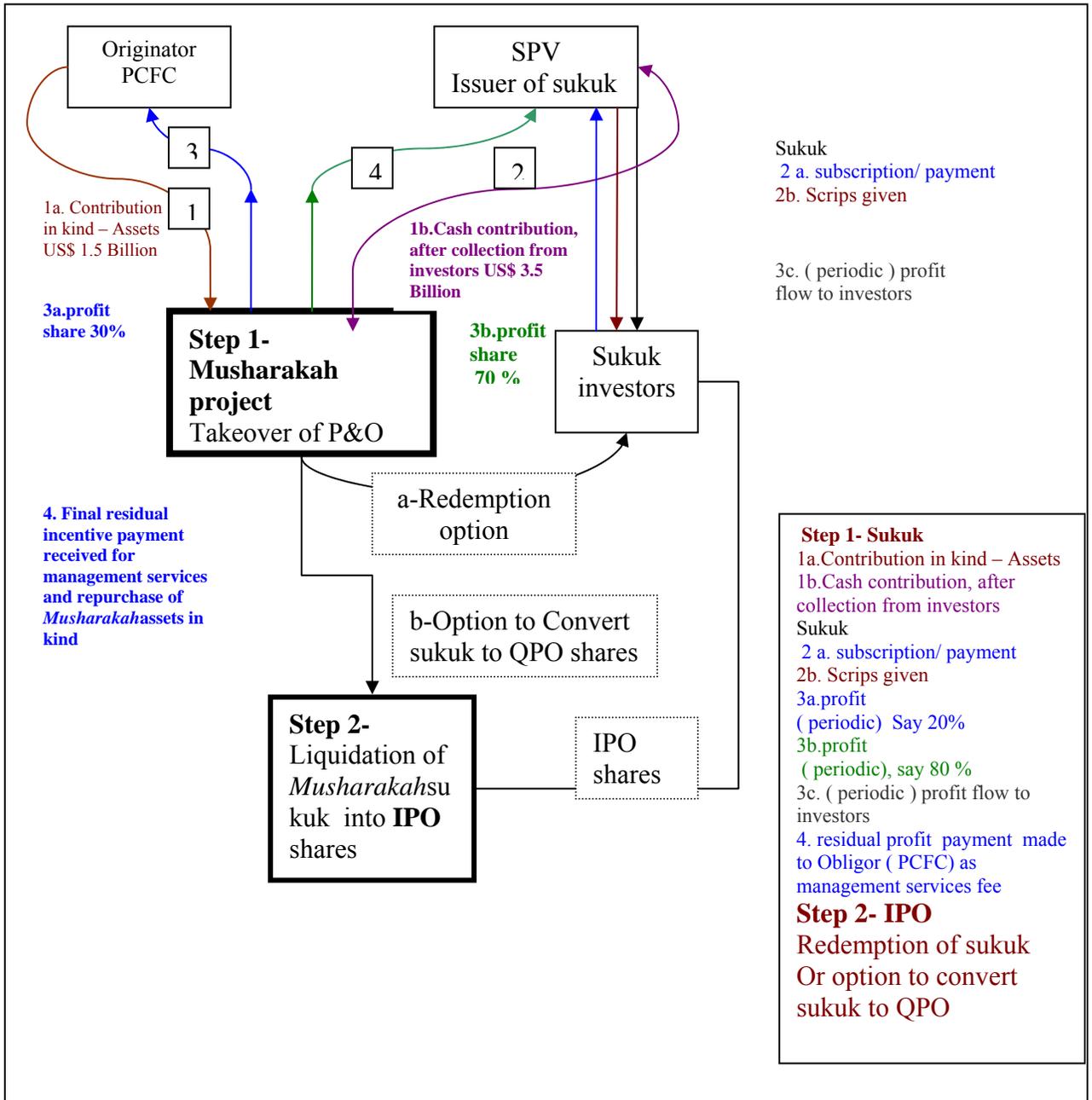
Redemption Date = 7.125 percent per annum of issue price (fixed return)

If Payment to be made to sukuk holders on final or mandatory redemption =10.125 per cent per annum.

The PCFC *Musharakah* Sukuk helped finance the takeover of P&O Worldwide by the Dubai Ports Authority. It is also commonly known by the name Dubai Port (DP) World sukuk. The issue size was the biggest in size at that time. The Sukuk was used as a step before IPO. Sukuk holders were given the opportunity to convert to QPO shares if they wish so at the time of QPO offer.

Figure 4.2

The PCFC Sukuk Structure



Source : Author

4.2.3 The Solidarity Trust Services Limited (STS) Sukuk (2003)

The Solidarity Trust Certificates (sukuk) were originated by the Islamic Development Bank (IDB) and issued on February 12, 2003 by the Trustee namely, Solidarity Trust Services Limited (STS), incorporated in Jersey. The Law Debenture Trust Corporation was the Transaction Administrator for the sukuk.

It is pertinent to highlight the status of the IDB, as one of the elite group of multinational development institutions which have been granted a zero risk category in the Basel II risk categorization. It stands as a good sample for review as an international development bank with multidimensional presence, especially in the developing world and the Middle East. For carrying out sukuk activity, it is large enough in terms of funds available to it and its clientele's base is very well diversified across many countries (especially its member countries) and varying nature of projects. It does have a developmental role and its funding is primarily through member countries which have funded it. For local banks or other multinational banks to undertake sukuk activity, the parameters would change and so would the risk weighting for capital adequacy.

4.2.3.1 Main features of STS Sukuk

The sukuk were issued on 12th February 2003 and shall be redeemed in full on 12th August 2008 (maturity Date) unless Dissolution Event (given in conditions) occurs before it. . Periodic Payments on the trust certificates shall be at a fixed rate of 3.625% p.a on 12 February and 12 August till 12th August 2008 inclusive or an earlier Dissolution date if triggered. The Issue price of the US \$ 400,000,000/- Trust certificates was at 99.489% of the aggregate principal amount. The Trust Certificates are listed on the Luxembourg Stock Exchange and registered in global form, deposited and registered in the name of nominee of a

common depository of Euroclear Bank S.A/N.V as operator of the Euroclear System and Clearstream Banking, Luxembourg.

The Trustee appointed ICD (International Corporation for the Development of the Private Sector) to service the sukuk assets. ICD delegated the responsibility to IDB, while remaining responsible to the Trustee for servicing the Sukuk Assets. The trustee purchased sukuk assets from ICD (which in turn had purchased them from IDB).

The portfolio of sukuk assets purchased by the trustee comprises *Ijara'h* (lease) contracts, *Murabaha* (conditional sale) and *Istisna'a* contracts (conditional sale of items to be manufactured), with the majority amount (51%) to comprise *Ijara'h* assets, for the portfolio to remain Islamic and pay out fixed rate of return.

Trustee has the benefit of guarantees from IDB and undertaking from IDB (the guarantor) to repurchase all the sukuk assets owned by the Trustee, upon maturity of the trust certificates or if earlier, upon occurrence of a dissolution event. Recourse in respect of the trust certificates depends on the performance of the guarantor, under inter alia, such guarantees and repurchase undertakings.

IDB has guaranteed any shortfall in the payment of scheduled installments (due) regarding sukuk Assets, needed to pay the certificate holders on the due dates. To ensure timely payments, IDB has agreed to provide an interest-free facility for limited periods to the trustee.

Through this mechanism of creation of sukuk, described above, the bank is transferring ownership from itself to the SPV and eventually claims on the assets being held by the certificate holders through sukuk. This sukuk, in effect securitizes IDB assets.

Given below is the detailed description of one of the intricate sukuk structures, namely the Caravan I issued in 2004.

4.2.4 Caravan I Sukuk

Caravan I was an innovative variable rate Auto-backed Sukuk. With February 2004 as its closing date, the sukuk shall mature on July 8, 2009 unless redeemed. This is a Two-tier structure involving securitisation of automobiles (Inventory). Owing to the Saudi government regulations⁶⁹ (not allowing transfer of assets to non Saudi entities) The structure was quite complex⁷⁰ enabling compliance with all the Saudi Arabian governments' legal requirements amicably as well as safeguarding the interests of the international investors, while remaining Sharia'h permissible. Caravan I Limited is a Special Purpose Vehicle (SPV) created for the purpose for issuing the sukuk. It is incorporated with Limited Liability in the jurisdiction of Jersey. It is linked to its sister Special Purpose Vehicle termed "Purchaser" (namely Al-Karam) incorporated in Saudi Arabia, which purchases the assets from the originator (HANCO, which is the manufacturer of the automobiles in Saudi Arabia) and receives the funding generated through sukuk issuance from Caravan I. Caravan I Limited issues Ijara'h sukuk (for SR 98 million) and Redeemable Participating Shares (all totaling to Saudi Riyal (SR) 102,167,281.20)⁷¹. It advances these proceeds to the Saudi Arabian SPV, Al-Karam ("purchaser") which uses them for purchase of assets (vehicles) (and lease rental contracts) from the originator, HANCO (a Saudi Arabian rental and car leasing company). HANCO

⁶⁹ According to the Saudi Arabian Law, assets cannot be pledged to companies outside Saudi Arabia. ("Islamic Finance, Shariah, Sukuk & Securitisation", pp15, Lovells, Client Note.

⁷⁰ The Caravan I Sukuk was awarded the most innovative product structure of the year (2005). It had to be structured in a manner that the Saudi government regulations were complied and the investors were also satisfied, regarding their ownership claim and risk factors in payment of principal and maturity value of the sukuk.

⁷¹ The total value of the sukuk issue is Saudi Riyal (SR)98,000,000.

has subscribed to the full amount of Redeemable participating Shares, throughout the term of the transaction and paid SR 4,167,281.20 (at closing date of the sukuk issue offer), for the purchase. From these shares, HANCO is entitled to a profit –sharing dividend after redemption of the Sukuk in full. HANCO manufactures the auto vehicles under consideration (the underlying assets). According to the terms of the contract, HANCO shall sell these vehicles to Al Karam. By (before) May 8, 2007, the vehicles would be completely manufactured and ready to sell to Al Karam. On May 8, 2007, Al Karam shall pay (is expected to pay) the issuer (Caravan I) SR 6,000,000/- resulting from sale of the Vehicles bought from HANCO and the cash available in the excess spread account and the issuer's cash account. This Balloon payment is expected to redeem the outstanding balance on the sukuk. A minimum reserve level of SR 2.5 million will be maintained by the issuer in the SPV cash account, from end of June 2004 throughout the life of the Sukuk. Dividend and repayment of redeemable Participating shares will not be made before full redemption of sukuk. Sukuk returns shall be paid monthly (in arrears) on 8th of each month, the first one being on 8th March 2004. According to one legal source , Caravan I sukuk is a two tier structure with credit enhancement features of 15.39% over collateralization, a 4.25% equity tranche and 8.77% cash reserves to make it more robust. It also had embedded in it early warning triggers to mitigate its performance. This issue has been unrated, as it would have become more expensive. The legal opinion regarding the enforceability of profit sharing under Sharia'h was also not available and its only investor, Shamil Bank of Bahrain, was satisfied with the structure⁷².

⁷² 1) Caravan I- Offering Prospectus 2)”Islamic Finance, Shariah , sukuk and Securitisation”, Client Note, Lovells 3) <http://www.securitisation.net/international/article.asp?id=434&aid=3379>

Figure 4.3

Caravan I Sukuk Structure- step wise

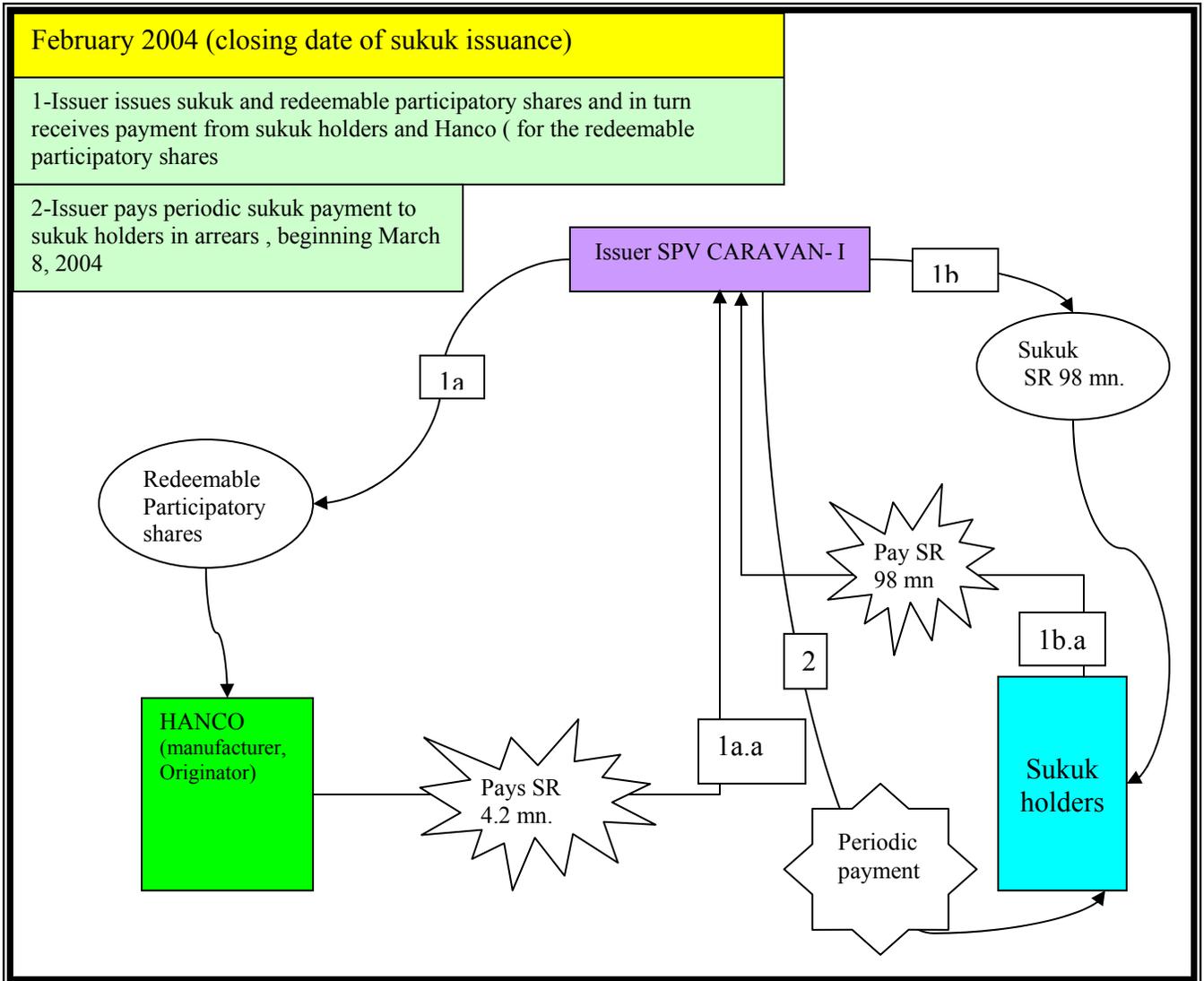


Figure 4.3 a

Caravan 1-The entities in two different jurisdictions

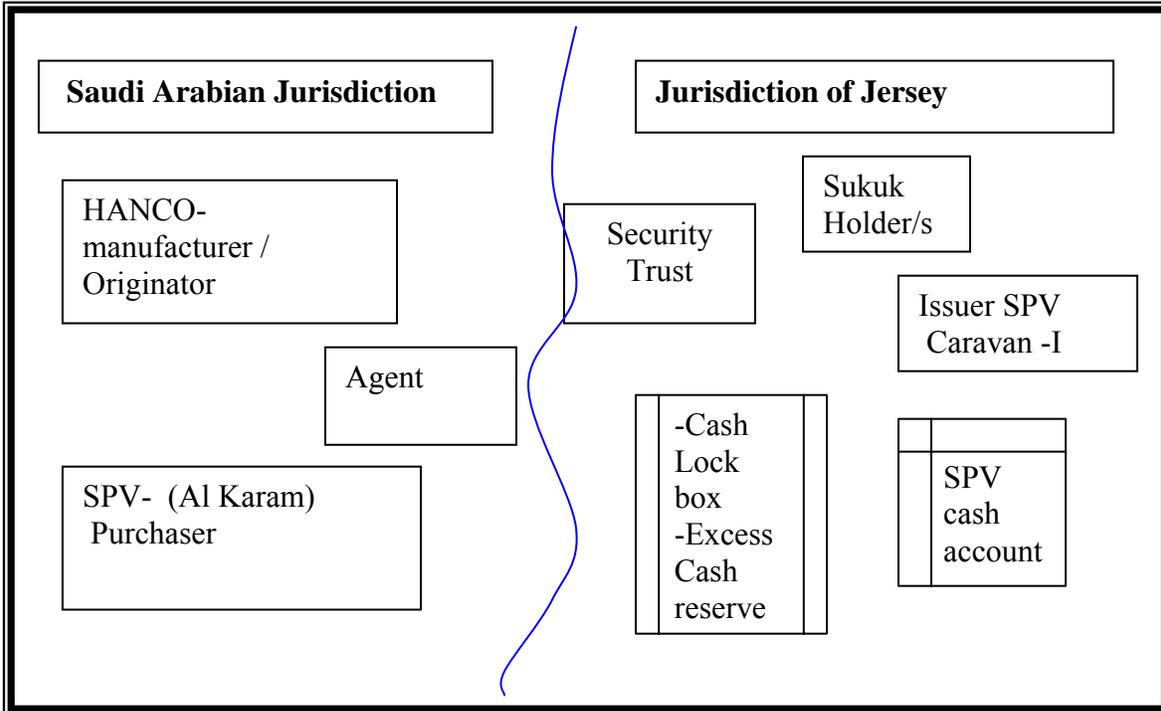
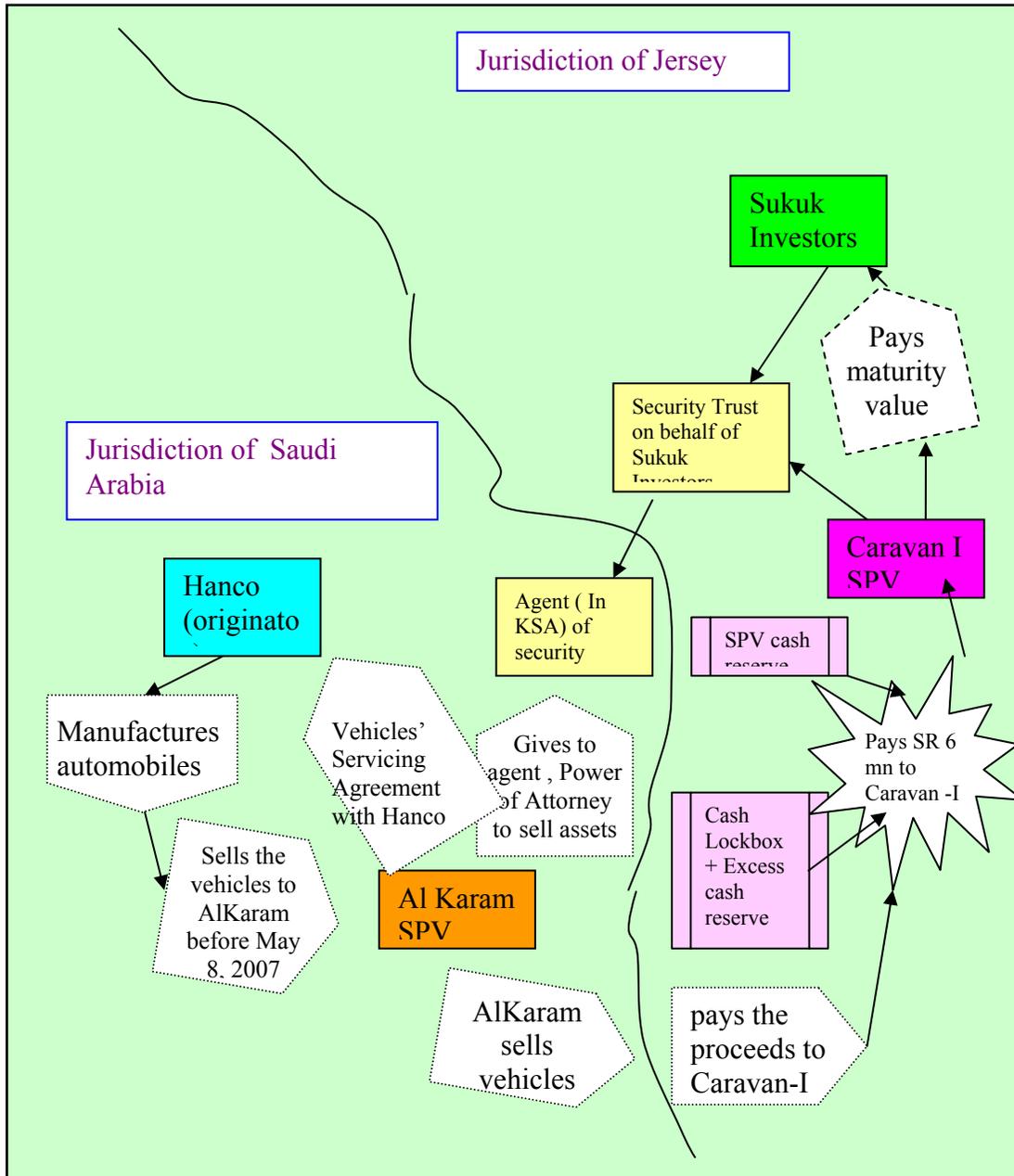


Figure 4.3 b

Caravan 1



As seen from the above three figures that are describing Caravan I's structure step-wise, it has been a very complex structure. The figures are an attempt to bring out a simplified

picture of the structure, without divulging from the basic facts. This sukuk securitisation structure has the main features of making /devising a bankruptcy remote SPV in Jersey, and another local (Saudi Arabian) SPV for acquiring the assets in Saudi Arabia. It was structured in such a manner that if any default occurs, investors principal and return can be safeguarded through the trigger clauses, excess cash reserves and recourse to the underlying assets that can be sold.

Other noteworthy structures that are two step sukuk, involving initial sukuk and later IPO, include Nakheel Sukuk, which is a US\$ 3.52 Billion Ijara'h Sukuk structure.

In addition, Tabreed Sukuk and Sanad Sukuk were innovative in their structure and underlying assets respectively. On the financial intermediation front, a new development has been the MayBank's Sukuk in Malaysia (May2008) for US \$ 300 million which qualified as tier II capital.

4.2.5 Salam Sukuk

The Central Bank of Bahrain undertakes to supply specific amounts of aluminium to buyers at a future date by receiving payments for it in advance.

Salam and Istisna'a are the only forward contracts that were allowed by the Holy Prophet (SAW) for advance payment against delivery of produce in future , owing to the non-availability of funds to poor farmers to grow the crops and for traders to do trade (Usmani T., 2001).

Salam mechanism is being used by the Central Bank of Bahrain to facilitate the financial institutions which have excess liquidity and make use of that excess liquidity in a Sharia'h acceptable manner through issuance of Sukuk called Salam Sukuk due to the underlying contract structure based on Salam mechanism, taking aluminium as the underlying real asset.

According to the contract structure, the Bahrain Monetary Authority (BMA) issues Salam Sukuk to Islamic Financial Institutions (IFIs), and receives payment for the sukuk, entitling the IFIs to future purchase of aluminium (specified amount). The IFIs appoint the government as their agent for selling the aluminium for them at a price agreed to be equivalent to the prevalent conventional short term money market rates. These sukuk mature in one month duration.

4.2.6 Sukuk Issuance by Financial Institutions

Till mid 2006 there were no sukuk issued by financial institutions, except the Islamic Development Bank's sukuk (2003) that we have analyzed. Nowadays (2007-8) sukuk issuance in banking sector has gained momentum. After corporate bodies, they are the second largest sector, in sukuk issuance. One of the early issues in this regard has been by Dubai Islamic Bank (in Dubai), floating a Sukuk –*Al- Musharakah* on February 2007 (due 2012) for meeting its funding needs. Standard Chartered Bank in Pakistan floated a privately placed Sukuk *al-Musharakah* with Sitara Chemicals in Pakistan, and similarly Meezan Bank (Pakistan) Limited⁷³ recently (in November 2007) committed itself to a, 2.5 billion, 5 ½ year tenure sukuk with a private construction company namely Eden Builders (in Pakistan) The former (Dubai Islamic Bank's sukuk) is an example of Sukuk issued by IFI for its fund generation while the latter two comprise joint (or partnership-based) pooling of funds for businesses, requiring medium to long term funding.

⁷³ Refer to www.meezanbank.com

4.3 Conclusion- Qualitative Cross-sectional Analysis of Sukuk

In this analysis a select variety of sukuk structures were described by culling the contract modalities from their prospectuses, accompanying their issuance. The examples picked were the WAPDA sukuk (2006) as a sample of Ijara'h sukuk , the PCFC sukuk (2006) as a Musharakah sukuk , the STS sukuk (2003) as a composite sukuk used for securitizing IDB's⁷⁴ assets , with a majority of Ijara'h contracts as underlying assets, and hence following the Ijara'h sukuk structure. In addition, the innovative and complex structure of Caravan I sukuk (2004) was also deciphered, It was a sukuk securitisation structure which had to overcome legal jurisdictional issues. Further the Sanad Sukuk and the Bahrain Monetary Authority's short term sukuk called Salam Sukuk were briefly discussed for their unique issues only. These analyses enabled an insight into the sukuk attributes, some of which shall be utilized in testing the hypotheses of the current research.

⁷⁴ an international development body in the financial sector

SECTION II

4.4 Sukuk and Sharia'h Objectives

4.4.1 Introduction

After the qualitative analysis of sukuk contracts, their main features, and main types have become clarified. This section provides further insight on sukuk by describing their varied underlying contract principles in comparison with the description of Investment sukuk by AAOIFI Sharia'h Standards (AAOIFI, 2004). It aims at investigating sukuk in order to prove or disprove Hypothesis No. 1 of the research. The Hypothesis states, "Sukuk conform to the principles of Sharia'h. By the principles of Sharia'h, the AAOIFI Sharia'h guidelines are meant as they provide a standard guide to the definitions of sukuk and their modalities. In this context the legal documents representing the sukuk contract at the time of their issuance, were described, analyzed and summarized in the preceding chapter. Now they shall be compared with the AAOIFI Sharia'h Standards for sukuk and underlying concepts where required.

4.4.2 Sukuk defined by the AAOIFI

Sukuk are scrips of entitlement to tangible and identifiable asset or pool of assets or rights of usage. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) classifies sukuk as Investment sukuk and defines them as certificates of equal value, entitling the owner or bearer to a claim over the financial rights and obligations represented by the certificates. All certificates represent a common share in the ownership of

the underlying assets that they represent, whether non-monetary assets, usufruct, services or a combination of these, including intangible rights, debts and monetary assets. Sukuk do not represent debt owed to the issuer by the certificates holder/s. They are issued on the basis of Sharia'h⁷⁵ – based contract/s following the Sharia'h rules of issuance and trading. Their trading is subject to the terms governing trading of the rights they represent. Their sharing of return is in accordance with the contract terms given in their subscription prospectus and the loss sharing is invariably, as a rule, in proportion to the certificates' value out of the total pool.

4.4.2.1 Classification

The Sharia'h Standards⁷⁶ of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) give the following classification of Sukuk or investment. They are grouped as:

- 1) Certificates of ownership in leased assets
- 2) Certificates of ownership of usufruct
 - (a) of existing assets
 - (b) of described future assets
- 3) Certificates of ownership of services of a specified party
- 4) Certificates of ownership of described future services
- 5) Salam certificates,
- 6) Istisna'a certificates,
- 7) *Murabaha* certificates,

⁷⁵ Sharia'h means Islamic law, the code of ethics and practice of Islam in every aspect of life. It emanates from the Divine rulings in the Holy Qura'n and the Sunnah (the preaching and practice of Prophet Mohammad (Peace be Upon Him)

⁷⁶ Shariah Standard No 17, Investment Sukuk, page 295-313, Shariah Standards 1424H-May 2003, Accounting and Auditing Organization for Islamic Financial Institutions

8) *Musharakah* certificates,

a) Participation certificates b) *Mudaraba* Sukuk and c) Investment agency Sukuk,

9) Muzara'a (sharecropping) certificates

10) Musaqa (Irrigation) certificates

11) Mugharasa (agricultural) certificates.

The Sharia'h Standard No. 17 of the AAOIFI (2004) further specifies that the investment sukuk can be issued through subscription procedure on the basis of any of the Sharia'h-nominated investment contract/s. These investment sukuk can be issued on the basis of (to securitize) underlying assets, that are tangible assets, and/or their usufruct. These assets and/or their usufruct shall be divided into equal shares and sukuk certificates be issued for their value, but as a whole they are undivided as total underlying assets. The contract of issue (the prospectus) is its main legal document. It describes the type of sukuk, the legal arrangement between the parties to the contract, especially the originator, the issuer (Special Purpose Vehicle, (SPV)) and the subscribers.

For the current research, the *Ijara'h* and *Musharakah* structures are tested for their Sharia'h compatibility, particularly the AAOIFI Sharia'h Standards. Representative samples of the sukuk are picked for this purpose. They comprise the WAPDA (Water and Power Development Authority, an autonomous body of the Government of Pakistan) sukuk (2006) for *Ijara'h* sukuk and PCFC sukuk for *Musharakah* sukuk.

4.4.2.2 *Ijara'h* Sukuk category

The group of investment sukuk that are called *Ijara'h* sukuk comprises the following types:

1) Certificates of ownership in leased assets,

2) Certificates of ownership of usufruct

- (a) of existing assets ,b) of described future assets,
- 3) Certificates of ownership of services of a specified party,
- 4) Certificates of ownership of described future services as given earlier.

Ijara'h Sukuk present an alternate Islamic investment opportunity with a regular periodic fixed or floating income stream, representing the pre-agreed rentals on the underlying *Ijara'h* contracts. They represent an undivided beneficial interest in the underlying assets, be they land parcels or building or project assets.

4.4.2.2.1 The underlying *Ijara'h* contract

The underlying mechanism of *Ijara'h* works within the *Ijara'h* sukuk. The word “*Ijara'h*” literally means “to give something on rent”. In Islamic jurisprudence, it has two meanings. Firstly, it means, “to employ the services of a person on wages given to him as a consideration for his hired services” . Secondly it means “to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him”. This class of *Ijara'h* is similar to the term “leasing”, in conventional finance, except for the *riba* element in conventional leasing. *Ijara'h* is used as a form of investment and a mode of financing in current Islamic financial practice.. (Usmani, Taqi, 2002) The *Ijara'h* contract can be explained with the help of the following scenario. Consider an owner of assets who rents out the assets’ usage rights to another party in return for a return (benefit) in kind (e.g. a portion of agricultural produce), or money income proportion decided before-hand. (These usage rights can also be sub-let). In this contract of renting out usage of one’s assets, the owner of assets becomes a lessor (called *Mu’jir*) the one receiving usage rights is the lessee is called *musta’jir*. The rent payable to the lessor is called “*ujrah*”. The leased asset (asset under *Ijara'h*) remains the property of the lessor, and the lessor bears all the risks related to the

asset except its maintenance and wear and tear, while in the use of the lessee. A pre-condition of effecting lease is that the subject of lease must have a valuable use. In addition, anything which cannot be used without consuming cannot be leased out. Hence money, eatables, fuel, etc. cannot be leased, as they would perish with consumption. (Usmani, Taqi, 2002). Cultivable Land is an ideal example of *Ijara'h* asset, as it can be cultivated, and the crops harvested, and the land returned to the owner. The *ujrah* (lease rent) of *Ijara'h* must be determined for the period of *Ijara'h* (lease) at the time of commencement of the *Ijara'h* contract. The rent is payable only after the asset is in the possession of the lessee. Traditionally, in the agricultural economies of the Indo-Pak sub –continent, *Ijara'h* has been practiced by the local population, between land owners and land cultivators (farmers).

4.4.2.2 Utility of *Ijara'h* Sukuk in practice

Generally speaking, sovereigns, municipal governments, autonomous bodies and corporate bodies around the world require medium to long term funds for their projects and hence seek fixed income securities with medium to long term maturities. In addition, mortgage specialists (institutions) and those financial institutions which have a portfolio of slow moving, medium to long term portfolio like mortgage based financing, residential and commercial property financing, machinery and fixtures financing portfolios, require “off-loading” the medium to long term “assets” by securitizing them. Therefore, securitisation occupies a major chunk of world financing. It gives the holder of securities (investors) a fixed or floating rate return over the life of the security till they mature. *Ijara'h* Sukuk structure and payoff matches the requirement of this kind of investors and is likewise in high demand.

4.4.2.2.3 Ijara'h Sukuk's structuring in practice

Under the *Ijara'h* sukuk structure, the originator of the sukuk, who owns the underlying assets, creates a Special Purpose Vehicle (SPV) to whom it sells the assets. The SPV in turn securitizes the assets and on their basis, issues the sukuk securities to investors. The SPV pays the purchase price of the assets to the originator, which then leases the assets back for its own use for the duration of the sukuk term and pays *ujrah* (lease rentals). The lease rentals correspond to the periodic sukuk payments and may also match the amount of sukuk payments due. This arrangement is termed a Sale and lease back arrangement. In many instances, the originators also make a repurchase agreement to repurchase the underlying assets back at the end of the sukuk term, at the pre agreed terms of the repurchase agreement, varying from case to case. If the securitisation is through an *Ijara'h* agreement of assets to SPV from originator, at the end of the Sukuk period, the *Ijara'h* contract is terminated and the residual assets if any are sold back to the originators (unilateral agreement to purchase the underlying assets) at a price that meets the maturity payments of the Sukuk

In order to assess whether the sukuk structure complies with the requirements of Sharia'h, particularly the AAOIFI Sharia'h Standards for Investment Sukuk and allied concepts, the methodology has been explained earlier and is now being used to test various characteristics of the *Ijara'h* Sukuk accordingly.

Table 4.1

Testing Ijara'h Sukuk for Hypothesis No. 1

		Hypothesis No.1	
		AAOIFI Sharia standards' compliant	
Sukuk structures	Characteristics		Remarks-Inference
Ijara'h Sukuk			
1.	The underlying asset	Yes	
2.	The contract of Ijara'h	Yes	
3.	The contract of sale and lease back	Yes but some clauses No	My Observations on - Sale and resale between the sukuk holders and the originator. -Predetermined resale price -Undertaking to repurchase
4	Distribution mechanism		
4a	(Return)rent distribution		
4ai	With originator	Yes	Rent paid by originator
4aii	With SPV	No effect	
4aiii	rent to sukuk holders	Yes	Although money market rates are used as a benchmark for determining the rent on underlying assets
4b	Sale and resale	Yes	mechanism contrary to Sharia'h
4bi	Originator	Yes	
4bii	SPV	Yes (No effect)	
4biii	sukuk holders	Yes	
4c	Loss/distribution in Ijara'h contract		
4ci	With originator	Yes	
4cii	With SPV	No effect	
4ciii	With sukuk holders	Yes	Sukuk holders as lessors, should bear risk of loss but sale and resale , and points

			No. 5 and 6 below cause distortion
	Overall risk of loss in sale and leaseback		Risk of loss lies with the originator, who is the seller, lessee, and repurchaser Reasons are points 5 and 6 below
5	Guarantees	No	Provided by originator of Ijara'h Sukuk
6	Repurchase Agreement	No	Provided by originator of Ijara'h Sukuk

4.5 Testing Ijara'h Sukuk for Hypothesis No. 1

Explanation of Table 4.1 above:

1) The underlying asset:

The Ijara'h contract requires the Ijara'h rentals from an underlying asset owned by the issuer of the Ijara'h rentals. Without ownership of the underlying assets there can be no Ijara'h contract.

The WAPDA sukuk under review, has, the Hydel Power units as the underlying assets. These assets have been leased to the originator, namely WAPDA.

2) The contract of Ijara'h

The contract of Ijara'h exists between the sukuk holders collectively known as the lessor, and the originator being the lessee. The contract conforms to the AAOIFI guidelines.

3) The contract of sale:

The contract of sale of the same underlying assets (the Hydel Power units) precedes the Ijara'h contract of the assets. Due to the sale preceding the Ijara'h, it is called a sale and lease-back transaction.

The Ijara'h sukuk can be certificates of ownership in leased assets, certificates of ownership of usufructs or certificates of ownership of usufructs of described future assets. (AAOIFI, 1424-5H/2003-4)

However, from the perspective of this analysis, one observation regarding the sale and lease back is that if it is either binding or understood that the buyer (sukuk holders in this case) is going to lease the asset to the same entity from whom the assets are bought , this can be interpreted as two interrelated contracts making up one sukuk, especially when both the sale and the lease back are for a monetary consideration . AAOIFI is so far silent on this matter⁷⁷. The AAOIFI approach in the Sharia'h Standards is that of giving the attributes of the contracts and their sub- types. However, it has to delve into the details of the contract structures , in order to guide in a more firm and clear manner, and curb malpractices.

4) Distribution mechanism

1) Return distribution

a) In Ijara'h Contract:

Based on the Ijara'h rentals from the underlying assets, and the agreement between the issuer and the subscriber, the Ijara'h rent rate is prescribed. The distribution of returns from the underlying contract to the owners of the Ijara'h rights is according to the terms of the Ijara'h.

b) Sale and Resale Contracts:

i) Initial sale by originator

⁷⁷ “3/1 Certificates of ownership in leased Assets:

These are certificates of equal value issued either 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 asset and recovering its value through subscription so that the holders of the certificates become the owners of the assets.” AAOIFI, Sharia'h Standards, (1424-5H/2003-4) p.298

The originator gets the initial sale price from sale of the underlying asset. The sukuk subscribers pay the price.

ii) Final sale by sukuk holders:

The sukuk holders sell the underlying asset through their agent, to the buyer, and receive the sale price.

2) Loss/distribution

In sale transaction the losses if any shall accrue to the buyer or seller according to the market dynamics. In the context of the sale of underlying asset in the Ijara'h sukuk, the initial sale of underlying asset from the originator to the sukuk holders is based upon the price assessed to be the correct price from the point of view of both the originators and the sukuk subscribers. Hence we rule out the chances of loss in the initial sale contract. Upon termination of the sukuk contract tenure, the underlying assets are sold by the sukuk holders in order to receive their initial investment back. Following market dynamics, technically speaking, and also from the point of view of Sharia'h, a loss or profit can occur. This loss or profit shall be borne by the sukuk holders. It is to be noted that none of the parties to a contract can guarantee the returns to any one (cite-quote source) It is to be seen, in the sukuk contract whether such a situation exist or not.

In the Ijara'h contract part in the sukuk, technically speaking there is no loss in terms of agreed rent receivable by the sukuk holders and the rent to be paid by the lessee, unless, of course the originator defaults. However, the Sharia'h overrules, any guarantee of returns to any of the parties to the contract. The SPV does not incur any loss or profit as it generally serves as an agent fully owned by the originator or partially owned by the

originator and other entities. The profit or loss, if any, actually accrues to the owners of SPV.

5) Guarantees

As per the rules of Sharia'h in general and sukuk or Ijara'h sukuk in particular, none of the parties to the contract (cite AAOIFI written separately in notebook) of sale or rent can guarantee the returns or principal to any of the parties to the contract (Mohsin, 2004⁷⁸). This condition is particularly more stringent in the cases of mudaraba and Musharakah based contracts. (2/2/1, p.57) According to the AAOIFI Sharia'h Standards (2/2/2, p 58), “ a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest- based loan since the capital of the investment is guaranteed, in addition to the proceeds of the investment....” However, it further says that if the guarantee is not part of the agency contract and the agent voluntarily becomes a guarantor in a different capacity, from that of agent, since a guarantee shall be liable even if the agent's duties have been discharged. Basically, this is a typical third party guarantee where the guarantor is not among the partners to the contract. Even voluntary undertaking to compensate an investment loss cannot be made by any of the partners, investment agents or mudaribs, and this type of financing too shall not be linked in any manner to mudaraba financing contract or investment agency contract. (7/6, AAOIFI, Sharia'h Standards). This rule applies to all types of contracts in Islamic finance and hence all types of sukuk.

The AAOIFI Sharia'h standards in general and the Standard No. 17 for Investment sukuk in particular do not describe any repurchase agreement. In its recent addendum, it

⁷⁸ See literature review, Chapter Two of the thesis

has ratified the purchase of leased assets by the lessee on the condition that the lessee is neither a partner, nor a Mudarib or an investment agent⁷⁹.

4.5.1 Observations

4.5.1.1 Observation on the Sale and resale contract

In the sale contract, the sukuk subscribers pay for the purchase of the underlying assets and get the sukuk scrips. At the end of the sukuk tenure, the sukuk are retired and the underlying assets sold back to the originator. The sukuk holders receive the payment. This requires some further explanations. At the end of the tenure of the sukuk, a predetermined amount (just like the maturity value of conventional bonds) is paid to the sukuk holders by the buyer who is the same originator of the sukuk having sold the assets to the SPV and hence the sukuk holders. Hence one can see a closed circular flow of transactions, which is very much akin to *riba*-based transaction, or can be termed as a back door to *riba*. Even if someone argues to the contrary, that it is not *riba*-based but a Sharia'h permissible transaction, this practice must be avoided, and must not be followed at all due to the following reasons. These types of transactions take out the asset-based spirit from the contracts and make them very inflexible with changing market conditions. They have disadvantages of severing the composite contracts from the real economic conditions, whose benefits and losses are not shared among the stake-holders even on the basis of the contracts they represent. AAOIFI on the other hand has not mentioned anything to the effect in its Sharia'h Standards

⁷⁹ http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf

“Fifth: It is permissible for a lessee in a Sukuk al-Ijarah to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided he {lessee} is not also a partner, Mudarib, or investment agent.”

(1424H/2003-4). In its statement or clarification regarding the sukuk⁸⁰ and particularly in Point No. Five it has stated the following:

“Fifth: It is permissible for a lessee in a Sukuk al-Ijara’h to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided he {lessee} is not also a partner, Mudarib, or investment agent.”

4.5.1.2 Observation on Sale and resale

These sale cum lease-back plus final sale-back transactions are all going in a round circle, joined together through the same entities. The SPV too is 100% owned by the originator who is the initial seller, the lessee and the final purchaser, irrespective of the existence of the underlying asset. In fact, even if the originator unilaterally undertakes to purchase the assets, the substance of the contract should be looked at, meaning that the contracts are nullifying their individual effects and producing a *ribawi* transaction. Traditionally, the use of SPV has been a legal gimmick, to allow financial institutions undertake businesses which they cannot undertake under law. Similarly, they circumvent the law of the land, in terms of delineating the assets “sold” to the SPV, from the reach of the originator’s creditors and stakeholders, particularly in cases of bankruptcy. However, when we look at the benefits to all stakeholders as well as the actual economic meaning of these SPV, their distortive attributes become unearthed. Hence it is believed that SPVs should not be used for exploitative ends.

4.5.1.3 Observation on SPV

The Special Purpose Vehicle (SPV) acts as issuer of the sukuk on behalf of the originator or seller of the assets. It is mostly 100% owned by the originator, throughout the tenure of the sukuk. It also acts as agent of the sukuk holders. Sometimes another SPV is created to act as

⁸⁰ http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf

agent of the sukuk holders. From distribution point of view, the distribution to the SPV implies the distribution of returns risk to the owner/s of SPV.

In this rather circular flow of funds and assets, the main exposure of investors is on the originators, and payment guarantors (if any) and their fund generating capacity. The legal structure of the contract has a number of safeguards in place that legally make the underlying assets or the underlying project/s in possession of the SPV independent of the originators control and the payments mechanism secure from the sukuk investors' perspective. They are safeguarded regarding the receipt of their periodic payments and maturity or redemption value. At the same time, legally, the sukuk are Sharia'h permissible.

4.6 Sukuk based on the principles of partnership (*Musharaka*)

(Musharakah Sukuk, Mudaraba Sukuk and Investment Agency Sukuk)

Musharaka or Sharia is the Arabic word for partnership. *Musharaka* Sukuk are defined as equal value certificates, issued for using the funds received, for establishing a new project, or development and financing a business activity on the basis of any of the partnership contracts. The certificate holders become owners of the underlying project/s, business or assets with their respective sukuk. The nature of underlying operations of Musharaka certificates, further sub classifies it into Participation certificates, Mudaraba Certificates, or Investment agency certificates.⁸¹ When all stakeholders (sukuk holders and managers of the business) are equity holders and they share the profits and losses of business according to the rules of Musharakah contract, this type represents Musharakah sukuk or Participation sukuk. When the sukuk holders contribute equity while the business is managed by a separate body

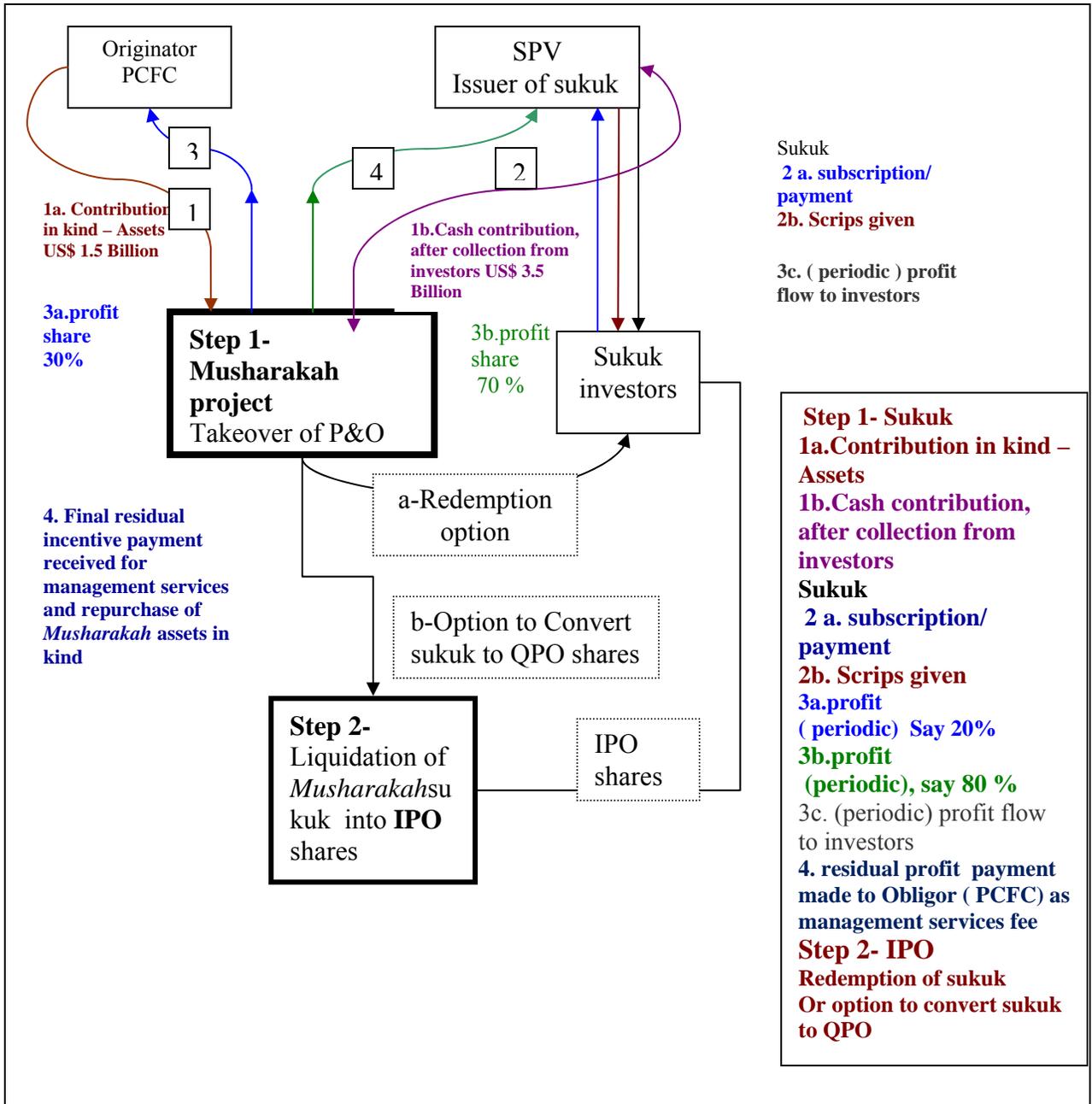
⁸¹ “ Shari’a Standard No. 17, Investment Sukuk” , pp 299, “ Shari’a Standards” ,

(which is the Mudarib), and the profit and loss sharing follows the rules of Mudaraba contract, this is a partnership through equity and service and hence

The sukuk are called *Mudaraba* sukuk. In addition, if the sukuk holders are equity holders (and partners) in the underlying project or activity, and an agent is appointed to manage the operations of the sukuk on behalf of the sukuk holders, this arrangement is classified as an Investment agency sukuk under the main classification of partnership –based sukuk. (AAOIFI, 2003-4, p.299).

Figure 4.2

The PCFC *Musharakah* sukuk structure



Source Author, Conference paper, IIUM conference, April 2007, Kuala Lumpur.

Note: the generic model is made, as inferred from the AAOIFI Sharia'h Standards.

Following the same pattern of analyzing as used for Ijara'h sukuk, we analyze PCFC sukuk *Musharakah* sukuk as a representative example. In order to test this *Musharakah* sukuk

structure for its compatibility to the Sharia'h Standards as given in Hypothesis 1, we use the following table:

4.6.1 Testing of Musharakah Sukuk for Hypothesis 1

Table 4.2
Testing Musharakah Sukuk for Hypothesis No. 1

		Hypothesis No.1	
		AAOIFI Sharia standards' compliant	
Sukuk structures	Characteristics		Remarks-Inference
Musharakah Sukuk			
1.	The underlying asset	Yes	
2.	The contract of Musharakah	No	
3	Distribution mechanism		
3a	Profit sharing		
3ai	With originator	No	
3aii	With SPV	No Effect	
3aiii	With sukuk holders	No	
3b	Loss/distribution in Musharakah contract		
3bi	With originator	No	
3bii	With SPV	No effect	
3biii	With sukuk holders	No	No. 5 and 6 below cause distortion
4	Guarantees	No	Provided by originator of Sukuk
5	Repurchase Agreement and /or redemption price	No	Provided by originator of Sukuk

4.6.1.2 Test results regarding Hypothesis 1 for Musharakah sukuk

(Explanation of Table 5.2 above)

1) The underlying asset or project:

The Musharakah agreement requires an underlying asset, business or project with a value, to be held and run on the principles of Musharakah. The examples of Musharakah sukuk reviewed, did have a Musharakah project held as a Musharakah , and in this context complied with AAOIFI Sharia'h standards for Musharakah sukuk.

2) The Underlying Contract:

The Musharakah sukuk is based on the contract of Musharakah between the parties to the contract. The parties to the contract are the Originator and the sukuk holders through their representative or agent. In the contract of Musharakah profits from the underlying business project are shared according to the proportions agreed among the contributors of capital i.e. the partners to the Musharakah and losses are shared among partners according to the proportion of capital contribution by each partner.

In the Musharakah sukuk contract, the sukuk subscribers pay for their proportionate equity contribution in the underlying asset, business or project. The sukuk represent their ownership in the underlying asset, project or business during the tenure of the sukuk. Similarly the originator/s too have contributed to the underlying project either in monetary terms or in kind, but with an assessed value, which represents the originator/s' proportion of equity capital contribution in the project. At the end of the sukuk tenure, the sukuk are retired.

Following the market mechanism, technically speaking the underlying assets or business should be sold out at the prevalent market price and the sukuk holders should receive the market payment.

Upon review of the sukuk prospectuses, it was seen that the originator and the SPV share the profits according to the rules of Musharakah but the SPV distributes it onwards to the sukuk holders according to pre-determined rates, both if the sukuk holders opt for the option of conversion of sukuk into shares as well as if they exercise the redemption option..

This arrangement of fixed rate of return per investment made, is contrary to the rules of Musharakah and contrary to the description of the Musharakah sukuk by AAOIFI Sharia'h Standards.

3) Distribution of Profit and loss among partners:

Giving a fixed return to sukuk holders means that the sukuk holders do not share any business profits as well as losses with the other partner, which is the originator. Hence the distribution of profit as well as losses, if any, between the key stakeholders, i.e. the originator and the sukuk holders does not comply with AAOIFI guidelines.

The Special Purpose Vehicle (SPV) acts as issuer of the sukuk on behalf of the originator or seller of the assets. It is mostly 100% owned by the originator, throughout the tenure of the sukuk. It also acts as agent of the sukuk holders. Sometimes another SPV is created to act as agent of the sukuk holders. From distribution point of view, the distribution to the SPV implies the returns to the owner/s of SPV. The AAOIFI Sharia'h Standards do not mention any SPV or its role in the issuance of (any) sukuk.

4) Guarantees

AAOIFI has not given any requirement of a guarantee of periodic returns or principal to the sukuk holders. Hence, any guaranteed returns or guaranteed maturity value is contrary to the

AAOIFI guidelines and the principles of Sharia'h. In addition AAOIFI has recently added⁸² its viewpoint on the matter as follows:

“2/2/1 The prohibition against seeking a guarantee in trust contracts is more stringent in Musharaka and Mudaraba contracts, since it is not permitted to require from a manager in the Mudaraba or the Musharaka contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment.”

In the rules of Sharia'h in general and the Sharia'h rules for sukuk or Musharakah sukuk in particular, none of the partners in the contract can guarantee any other partner's returns or principal (Khan M.,2001) (AAOIFI,2003-4) . This rule applies to all types of contracts in Islamic finance and hence all types of sukuk.

5) Repurchase Agreement and /or redemption price:

Fixing before hand the maturity price of the Musharakah sukuk is contrary to the AAOIFI Sharia Standards for Musharakah sukuk as well as the Musharakah or Sharika principles given by it.

Very recently, AAOIFI has made further clarifications regarding sukuk in an addendum. The following excerpt from it shall further clarify the point:

“Fourth: It is not permissible for the Mudarib (investment manager),sharik (partner), or wakil (agent) to undertake {now} to re-purchase the assets from Sukuk holders or from one who holds them, for its nominal value, when the Sukuk are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the

⁸² http://www.aoifi.com/aoifi_sb_sukuk_Feb2008_Eng.pdf

net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article(3/1/6/2)⁴of AAOIFI Shari'ah Standard (12) on Sharikah (Musharaka) and Modern Corporations, and Articles (2/2/1)⁵ and (2/2/2)⁶ of the AAOIFI Shari'ah Standard (5) on Guarantees. It is known that a Sukuk manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether the manager is a Mudarib (investment manager), Sharik (partner) or Wakil (agent) for investments.

In case the assets of Sukuk of al-Musharaka, Mudarabah, or Wakalah for investment are of lesser value than the leased assets of "Lease to Own" contracts (Ijarah Muntahia Bittamleek), then it is permissible for the Sukuk manager to undertake to purchase those assets - at the time the Sukuk are extinguished - for the remaining rental value of the remaining assets; since it actually represents its net value.⁸³

2/2/1 It is not permissible to stipulate in trust (fiduciary) contracts, e.g. agency contracts or contracts of deposits, that a personal guarantee or pledge of security be produced, because such a stipulation is against the nature of trust (fiduciary) contracts, unless such a stipulation is intended to cover cases of misconduct, negligence or breach of contract. The prohibition against seeking a guarantee in trust contracts is more stringent in Musharaka and Mudaraba contracts, since it is not permitted to require from a manager in the Mudaraba or the Musharaka contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment.”

⁸³ http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf

SECTION III

Structured Finance and Sukuk

4.7 Purpose of Structured Finance-Any alignment with Sharia'h?

Structured Finance is commonly employed in creating different levels of credit and transferring credit risk among or within financial institutions or different sectors of the economy.⁸⁴ In some of them, credit risk is transferred to various sets of investors through tranching of claims, into junior, mezzanine and senior debt. However, whether we can use structured finance in the same manner for the same purpose or whether there are any other applications of it in Islamic finance, is our topic of discussion here. Bonds and securities in conventional finance are mostly products of securitised deals, comprising of assets (mostly debt) which are repackaged into securities and sold off to investors, at agreed prices. While the predominant majority of bonds are backed by financial assets, which (as explained in literature review section), are debt instruments, bonds backed or based on equity assets and based on real assets also exist. Examples include mortgage-backed securities, or mortgages sold and resold as securities.

4.7.1 Exchange/sale of commodities in profit-making transactions

According to the Islamic injunctions, in any transaction for profit-making, an exchange of commodities is necessary. In exchange of commodities, value addition takes place and risk

⁸⁴ Fender I., Mitchell J., “ Structured Finance : Complexity , risk and the use of ratings” BIS quarterly, June 2005.

is borne by the owner of the commodities, who sells them at cost plus margin. This additional margin is the lawful profit of the seller/trader.

Islam does not recognize trade in financial assets (monetary assets) because earning money on money is strictly prohibited and termed “*riba*” or usury, which is banned in very strict terms in the Holy Qura’n (Al –Qura’n, 2:275) and through the Sunnah⁸⁵. Hence bonds that represent debt and provide a return that is interest (return on money) are not permissible in Islamic Sharia’h.

4.7.2 Sukuk and Conventional Bonds

Sukuk were described as equity bonds, meaning a bond-like mechanism and an underlying equity stake, perhaps implying a profit and loss sharing on the basis of equity partnership. This was hence perceived as a very powerful combination, in addition to their major role in fund generation by bringing into use the otherwise idle property assets of governments and autonomous bodies, and corporate bodies, enabling large scale project developments and infrastructure development programmes. However, AAOIFI Sharia Standard No. 17, (2003-4) describing Investment Sukuk very clearly states that sukuk are not conventional bonds. Hence they cannot be made to deal in instruments which involve purely financial (money) assets, or its other substitutes. Sukuk cannot be the typical conventional bonds nor can they provide credit tranching in that manner. In addition, trading in debt is prohibited according to the Sharia’h Standards.

Hypothesis II:

“Sukuk are based on different securitization than that adopted in conventional instruments”

⁸⁵ Refer the Ahadith on Riba and its types, Annex I

For testing Hypothesis II, the features of conventional asset securitization are considered and compared with what the AAOIFI's prescribed sukuk are and to what extent the sukuk can go, considering the limits and permissibilities of Islamic Sharia'h principles. This securitization angle for sukuk is taken in consideration to the study of sukuk undertaken earlier for Hypothesis I and sensing the need for securitization in Islamic Financial Institutions. Hence the case for sukuk as securitization instruments emerges on this basis. In this hypothesis testing, the AAOIFI (Sharia'h standard No. 17) prescribed attributes of sukuk are considered.

Asset Securitization:

In conventional finance, the term "Asset securitisation" denotes selling or lending of financial asset portfolios in return for direct funding by investors. It constitutes a large proportion of financial activities worldwide and is popularly used by financial institutions. They usually involve the selling of underlying asset, moving it off the balance sheet, grouping them into a portfolio that is sold out (the assets can be individually illiquid). This also involves additional measures taken to reduce risk of default of underlying assets, (called credit enhancement) and tranching, meaning differentiating a pool of assets further into classes of securities (Class A, B etc.) carrying different pricing to attract different types of buyers.

Historically speaking, the origin of Asset Securitisation in financial institutions evolved from those financial institutions whose funds were committed to long term investments like home mortgages. They needed to free up capital from these long term commitments .Hence through the adoption of asset securitisation mechanism they were able to generate fresh cash

inflow from securities' investors (bonds' buyers) in exchange for periodic returns and maturity value to investors in future. Nowadays, the conventional securitisation by banks/financial institutions comprises loans (bank assets) of different types and maturities. These are sold out as securities (securitizing them) in a number of steps, at agreed prices to interested investors. Usually a middle party in the shape of an institutional purchaser of the loans or a Special Purpose Vehicle (SPV) is involved. Securitisation of receivables, advances, loans, Mortgage loans (mortgages) as well as other types of assets can be carried out. These can be one-off transactions of securitisation or a continuum of transfers of transactions taking place. The loan transactions are interest-bearing. The future value of the assets and their related risk-based cash flows (including interest revenue) are discounted to arrive at the present agreeable price between the contracting parties.

The Underlying assets can vary, depending upon the type of asset/s, their maturity, collateral and risks involved. For example a manufacturing company can securitize its inventory (raw material , work –in –process as well as finished goods inventory) by offering securities (either bonds or sukuk) to investors at a certain rate of return, fixed or floating , (unencumbered or encumbered). The assets sold or lent may or may not be financial assets, depending upon the nature of the entity securitizing its assets. The common features in most asset securitisation are usage of non-traded or illiquid assets (utilizing their cash flows) by converting them into tradable assets called asset-backed securities, or ABS.⁸⁶

⁸⁶ To quote Eugene A. Imhoff, Jr. (1992), "...a transferor-seller-originator has financial assets that it wishes to transfer to a transferee-buyer-investor, usually with the structuring assistance of a facilitator or special purpose vehicle, to raise new capital.

The Asset securitisation activity in traditional as well as synthetic form is one of the most popular and growing activity for banks and financial institutions in the conventional banking system in the US, Europe, North America and other countries, since the late eighties and early nineties. It gained momentum in the mid to late nineties onwards.

In accounting or Balance sheet terms, given below in a tabular form is an example of Asset Securitisation where the loan amount is the financial asset being securitised. Table 4.3 shows the simplified accounting view. This is explained as follows. Take for instance, an institution or a Financial Institution whose assets comprise Accounts Receivables (\$100) Prepayments (\$50), Short Term Loans (\$200) and medium to long term loans (\$600). These are balanced (funded) by the deposits (\$800) and Shareholders Equity (\$150).

Table 4.3
A Financial Institution's Balance Sheet

1A- without securitisation

Assets		Liabilities and Equity	
Accounts Receivable	\$100	Deposits	\$800
Prepayments	50		
Loans (<i>short term</i>)	200		
Loans –Tranche A (<i>medium to long term</i>)	600	Shareholders' Equity (<i>approx. 8%</i>)	150
Total Assets	\$950	Total Liabilities And Shareholders' Equity	\$950

1B-

Assets		Liabilities and Equity	
Accounts Receivable	\$100	Deposits	\$800
Prepayments	50		
Loans (<i>short term</i>)	200		
Loans tranche A Securitised (<i>medium to long term</i>)*	0		
Loans tranche B- (<i>medium to long term</i>)	600	Shareholders' Equity (<i>Approx. 8%</i>)	150
Total Assets	950	Total Liabilities And Shareholders' Equity	950

Notes: Rate of return received from Tranche A loan =5%; Rate of return from new Tranche B loan =6.5%; The bank also earns fees for management of Tranche A loans on behalf of the SPV in the securitisation deal and an originating fee (% of loan amount) for generating fresh loans.

1C

Assets		Liabilities and Equity	
Accounts Receivable	100	Deposits	800
Prepayments	50		
Loans (<i>short term</i>)	200		
Loans tranche A- securitised (<i>medium to long term</i>)*			
Project Finance	600	Shareholders' Equity (<i>approx. 8%</i>)	150
Total Assets	950	Total Liabilities And Shareholders' Equity	950

Notes* Tranche A is securitised, and the funds received employed in project finance with High risk /high return. Rate of return received from Tranche A loan =5%; Suppose the rate of return from new Tranche B loan =6.5%; The bank also earns fees for management of Tranche A loans on behalf of the SPV in the securitisation deal and also an originating fee (% of loan amount) for generating fresh loans.

In Table 4.3, 1A an initial tranche A (of medium to long term) loan is securitised as shown in (1B) and replaced with a fresh tranche of the same amount⁸⁷, to show that the loans-generation turnover increases and the bank is able to generate fresh loans, supposedly at better rates. Improved return from the loans and management fees and originating fees from the securitised portfolio shall improve the Earning Ratio. Similarly, in 1C, Tranche A loan portfolio (in 1A) is securitised and used for project finance (in 1C). In this example the bank diversifies its asset portfolio by employing the cash/funds received in a high risk /high return business as compared to the loan tranche securitised. It still earns the management fee and originating fee from the securitised Tranche A, while it is off the balance sheet.

Hence, such “asset transfers” can make the banks’ balance sheets efficient, while essentially improving the cash flows required for generating more loans or for utilizing elsewhere, say, project finance at high risk /high return. The financial institutions can utilize the funds obtained as a result of securitisation, in better investment opportunities and reshape or diversify its remaining portfolio in a given direction. They can also trade-off good quality, high performance but expensive portfolio and retain weak credit, within a certain regulatory band⁸⁸. This is an area for regulators to watch.

4.7.3.1 Securitisation Types

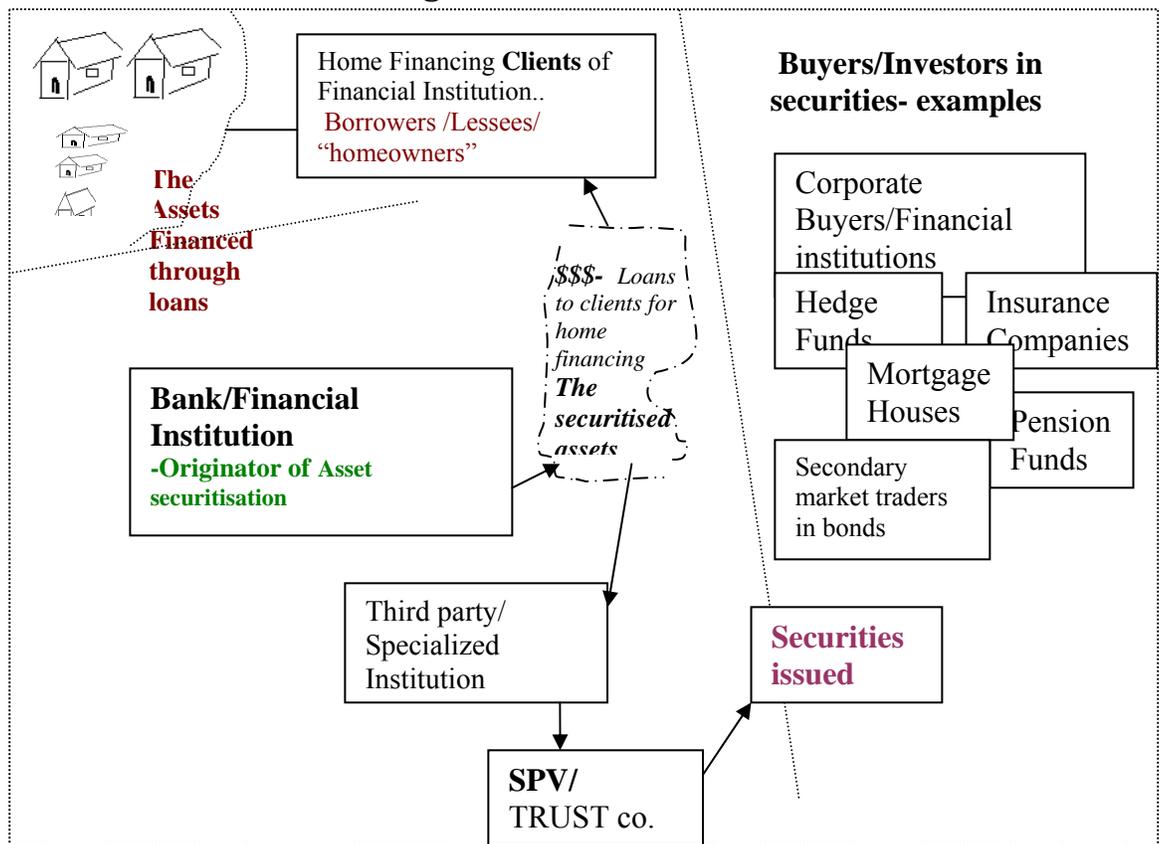
Structuring securitisation deals can take many forms. (See Figure 4.4) Asset securitisation takes place as a structured package deal involving, not just the final sale or lending to investors but also interim sale/transfers from one entity to another too. Legal technicalities are involved too. On the legal end, the sellers of securities usually create a Special Purpose

⁸⁷ for the sake of simplicity

⁸⁸ There can be other reasons for securitisation too.

Vehicle (an SPV) or Special Purpose Entity (SPE), as a separate legal entity to whom they transfer the assets (loan portfolio). This arrangement enables the sellers to detach themselves legally from the securitised issue once securitisation is effected. The seller in return sells the assets either directly or through another entity, (i.e. the trustee and SPV) to the bond (certificate) buyers. The SPV is usually fully owned by the seller.

Figure 4.4
Structuring Asset Securitisation



Source: Author's own. "Sukuk as an Asset Securitisation Instrument and its relevance for banks", Review of Islamic Economics, Volume 12, No. 1, 2008

4.7.3.1.1 Mortgage –Backed Securities

Here a mortgage-backed asset securitisation (MBS) has been picked as an example. This would be helpful in further explaining sukuk structures for contrast. In a bank loan for purchase of a house, the house to be purchased by the client (borrower) is to be mortgaged with the bank, in return for the bank financing. The bank receives periodic, say monthly payments from the client at a certain agreed market rate of interest (say 5%) for the duration of the loan, (say 25 years). This is typically a home mortgage (loan) transaction by a bank. Instead of holding the loan on its balance sheet for 25 years, the bank can sell the loan to a third party and receive funds for it today. It off-loads the loan from its balance sheet. In this

way the bank can generate more loans if it can work it out profitably⁸⁹. However, this is not as easy as it seems. The individual loans are illiquid. The bank cannot sell them individually, unless there are specialized institutional buyers (private or government sponsored, to purchase these portfolios from such banks and back it with its own clout /name in the market for securitizing. These entities⁹⁰ are known for this kind of activity. They can then repackage all loans from various banks (sellers) and place them in a trust/Special Purpose Vehicle (SPV) and then insure them against default⁹¹. The trust (SPV) finally sells them as securities (Mortgage-backed securities (MBS)) in the securities market. Tranching of asset pool may also be done to position the securities to different types of buyers (Ronal, 2005, pg17, Q3). The individual investors in the securities benefit from the pooled assets, instead of buying individual bonds of one bank. The investor may be someone who is diversifying its risk and return portfolio and would benefit from the nature of the transaction, or is specializing/concentrating in a particular activity/area, to reap economies of scale and benefits of specialization, or some other reason. The financing/payment of these mortgage-backed securities is done through the returns (payments by “homeowners”) from the mortgages (loans). The securities investors in MBS are paid a steady (pre-determined, pre-agreed) return on their investments and the final payment of principal at maturity.

Hence the illiquid bank assets (comprising loans in our two examples) are converted into securities that are sold in the capital market. This process is called securitisation. Common

⁸⁹Besides, the bank as a specialized credit institution performs its credit assessment and management /handling of the loan, due to which the third party buyer of loan pays it a certain fee (the originating fee) as a percent of the home loan amount.

⁹⁰ In the USA , a government sponsored enterprise (GSE) like Fannie Mae or Freddie Mac or another specialist firm in the private sector (but not a monopoly)

⁹¹ This improves the credit quality of the assets under consideration. This is a form of credit enhancement

examples of assets that are securitised are residential mortgages, vehicles loans (auto-loans), credit card receivables and leases. Asset backed securities (ABS) means all such securities' issues that are backed by assets other than mortgage assets.

Broadly speaking, securitisation is the process of pooling of assets⁹² in a separate legal entity, usually an SPV, and usually with further safeguards attached, like credit enhancement, and guarantees. The securitised assets are legally separate from the originator, and vice versa, i.e. the securities' holders do not have any claim on other assets of the originator (seller to SPV)⁹³. The cash flow from the securitised pool is the primary source of returns to the securities' holders.

Asset securitisation is not the same as collateralized debt or traditional asset-based lending. Here the securitised loans or other financial claims are assigned or sold to a third party, i.e. the Special Purpose Vehicle (SPV) or trust, which further issues the bonds/ debt instruments - the asset-backed securities. The resultant bonds' interest and principal payments rely on the cash flows coming from the underlying securitised assets.

4.7.3.1.2 Securitisation according to Sharia'h principles

Islamic financial instruments are categorized according to the nature of assets, as the instruments that represent real physical assets, those that represent usufructs, those that represent permissible debts and finally those that represent money. The former two classes are negotiable at market price (Ausaf Ahmed., & Tariquallah, Khan, 1998). Debts shall follow the rules of *hawala* and money shall follow the rules of *sarf* regarding their negotiability.

92 (mostly implying financial cash flows) from homogenous or similar assets (like mortgages, auto-loans , credit card receivables)

⁹³ except recourse to payments , in the case of guaranteed payments.

Those instruments that represent a mix of different categories are subject to the rules relating to the dominant category. (See Types of Islamic Financial Instruments and Their Rules of Negotiability pg 21, for details). Debt and money cannot be sold at a higher or lower price (neither at discount nor premium), Similarly money of any amount can only beget same amount if it is same kind of money (currency) and if it is in exchange of a different currency, then whatever in the spot exchange rate, and the exchange of the currencies shall also be spot⁹⁴ For sukuk to represent ownership in assets or usufruct or services, entitlements to risk and rewards from the underlying investment and be tradable instruments, they cannot represent debt or money. They can only represent the former two kinds, i.e. real physical assets and /or usufructs.

For a securitisation to be Islamic (Sharia'h compliant), it should be devoid of interest, involve exchange of an asset or its use (usufruct) and transfer of physical or constructive title. The flow of income to investors must be from underlying assets (or from rent of their usage) rather than debt instruments. Sale of debt on a margin (at a premium or discount) or a rate of interest is prohibited according to Islamic Injunctions). Therefore while sukuk structures can be used to securitize assets, this does not include securitisation of that asset portfolio of banks which comprises debt (lending).

There is high scope for sukuk as allowable, Sharia'h compliant securitisation mechanism to be utilized by (Islamic) banks as originators in the near future⁹⁵. It shall allow them to free-up funds trapped in illiquid assets and avail them more productively causing cash flow and earning (fees') enhancement and regulatory advantages of reduced capital requirements.

⁹⁴ based on the hadith on Riba Al Fadl, "Gold for gold ..." See Annex I

⁹⁵ Very recently, in August-September 2006, a Middle- Eastern corporate conglomerate by the name of Dullah Albaraka Group of Bahrain has issued its first –ever, sukuk. The Malaysian Rantau Abang Capital Berhad (RACB), a wholly owned subsidiary of Khazanah Nasional Berhad, issued Sukuk Musyarakah for Malaysian Ringgit (RM 10.0 billion.. These are fixed income securities.

Sukuk can be used as a mechanism /device for securitisation of the tangible, customer-based assets of Islamic banks.

4.7.3.2 The Unique Status of Islamic Banks' Asset Portfolio

The basic premise of Islamic financing is attaching of rewards with risk, (like selling the assets after purchasing them) and no rewards without taking the responsibility of risk. In addition, it is contrary to the separation of different types of parties to a transaction like separation of borrowers' risk and return from the lenders' risk and return⁹⁶. Islamic Finance proposes this sharing of profit and loss between the borrowers and lenders as equity participants, there is no concept of making money through lending money, in Islamic Sharia'h⁹⁷. Hence the Islamic Banking asset portfolio shall be comprising equity-participation based projects⁹⁸. Similarly the tranching of assets into different credit classes, from a securitised pool may not be possible in sukuk securitisation.

4.7.3.2.1 Islamic banks as buyers and sellers of real assets

To comply with the Sharia'h requirements and still do business, the Islamic banks have to purchase assets and resell them at a mark-up, which is a profit-margin as in everyday selling transactions. In some countries some Islamic banks, have, opened their own warehouses of merchandise which are sold at a profit margin, just like merchants or wholesalers. However, nowadays, generally speaking, the purpose of accessing (Islamic) banks is not to purchase

⁹⁶ As in conventional mechanism, money providers or lenders have a certain, risk-free return (except default risk) while the borrowers or users of money pay the cost of the money borrowed, whether the business makes profit or loss. The lender does not share the risk and rewards of the project/s undertaken by the borrower.

⁹⁷ Shariah is the rule of conduct /law, according to the teachings of the Holy Quran , and sunnah (the preaching and actions of the Holy Prophet, Mohammad, (May Peace be Upon Him)

⁹⁸ For equity participation, in my opinion, there ought to be participation or influence in decision-making too. However, this point is out-of- context at the moment.

the merchandise but to seek bank's monetary facility to help purchase the assets required or finance projects. This aspect is fulfilled by the Islamic banks by purchasing the assets, on behalf of their clients, according to the clients' specification (and inspection). Once the goods are ready, they are resold by the bank to the client⁹⁹. The client does not have the money to pay the bank, upfront. Therefore, the sale, in effect, is deferred sale¹⁰⁰ and the goods remain on the bank's balance sheet at their net book-value till all the amount is paid by the client. As a result of this practice, different types of banking transactions involving sale of assets or their usage have evolved^{101 102}. The practical essence of these transactions is sale-purchase of asset (or their use, as in *Ijara'h*). In this manner, the Islamic Financial Institutions/ banks are still (performing the evolved underlying role of) facilitating financing of assets and projects, while "Islamically," serving as sellers/merchants for their clients.

Hence, (in the opinion of the researcher), the need for securitisation for Islamic banks, arises more intensely from the fact that the assets which are practically being used by the clients and are in the clients' custody, are appearing on banks' balance sheets. This can make the balance sheets with physical and tangible assets, cumbersome in financial terms (with higher amounts of less liquid and at times ,slow moving assets) causing low asset turnover /low efficiency. In the absence of securitisation, some Islamic banks are managing their liquidity by concentration of very short term real assets with around three to five months' turnover¹⁰³.

⁹⁹ The resale may involve double taxation , but that has been sorted out in many jurisdictions , legally, like in the U.K

¹⁰⁰ The price of deferred payment deal is usually higher than that of the spot payment. This is permissible by Sharia'h.

¹⁰¹ namely *murabaha*, *Ijara'h*, *salam* and *Istisna'a*

¹⁰² Sharia'h does not allow short selling, and rules out any sale without possession as void.

¹⁰³ For instance , refer to Meezan Bank's (Meezan Bank Limited, Pakistan) Annual Reports, 2006, 2007, and see the overwhelming amount of *murabaha* financing , under the "Financings Subcategory, followed by *Ijara'h* financing, and yet a very small percentage of the long term housing Diminishing Musharakah Financing.

This would make the banks vulnerable to short term price fluctuations. In addition, it is seen that there is a concentration of Murabaha (deferred Murabaha) transactions among the financings of the Islamic Financial Institutions¹⁰⁴. Deferred Murabaha represents debt receivable and cannot be securitised. Similarly advance payments in Istisna'a, while the goods are not delivered, represent a prepayment, and cannot be securitised at any value other than par.

4.7.3.1.3 Sukuk Securitisation Structure-a facilitator in Islamic banking

Figure 4.5 depicts the sukuk asset structures 1a and 1b. This can be easily compared with Figure 4.4 (given earlier) depicting a conventional mortgage –based securitisation. In figure 5.2 the assets (houses) are purchased collectively by the bank and client in a Diminishing Musharakah arrangement¹⁰⁵, a product of Islamic Banking being practiced by Meezan Bank Limited in Pakistan. In the Diminishing Musharakah arrangement¹⁰⁶, usually the ratio of financing the asset price is 80:20 for the bank and client respectively¹⁰⁷. The customer joins in an agreement with the bank to keep on buying the bank's equity portion through periodic payments over a period of time. When the house is ready to be occupied, it would either be occupied by the customer or rented out to a third party. The revenue from this asset is the rent derived, which shall be shared in proportion to their equity proportions by the bank and

¹⁰⁴ Upon discussion with the bankers¹⁰⁴, it was found out that most of these deferred murabaha transactions are of short terms like three months to six months. Hence they fulfill the short term business requirements on the one hand and if they are paid within three to six months too, they do not need to be securitised, and fresh transactions take place, meaning that there is high volume of activity in Murabaha.

¹⁰⁵ (The term "Musharakah" is used for equity participation or partnership).

¹⁰⁶ the bank enters into a Diminishing *Musharakah* contract for the purchase of a house identified by the customer (and evaluated by the bank's appointed approved evaluator

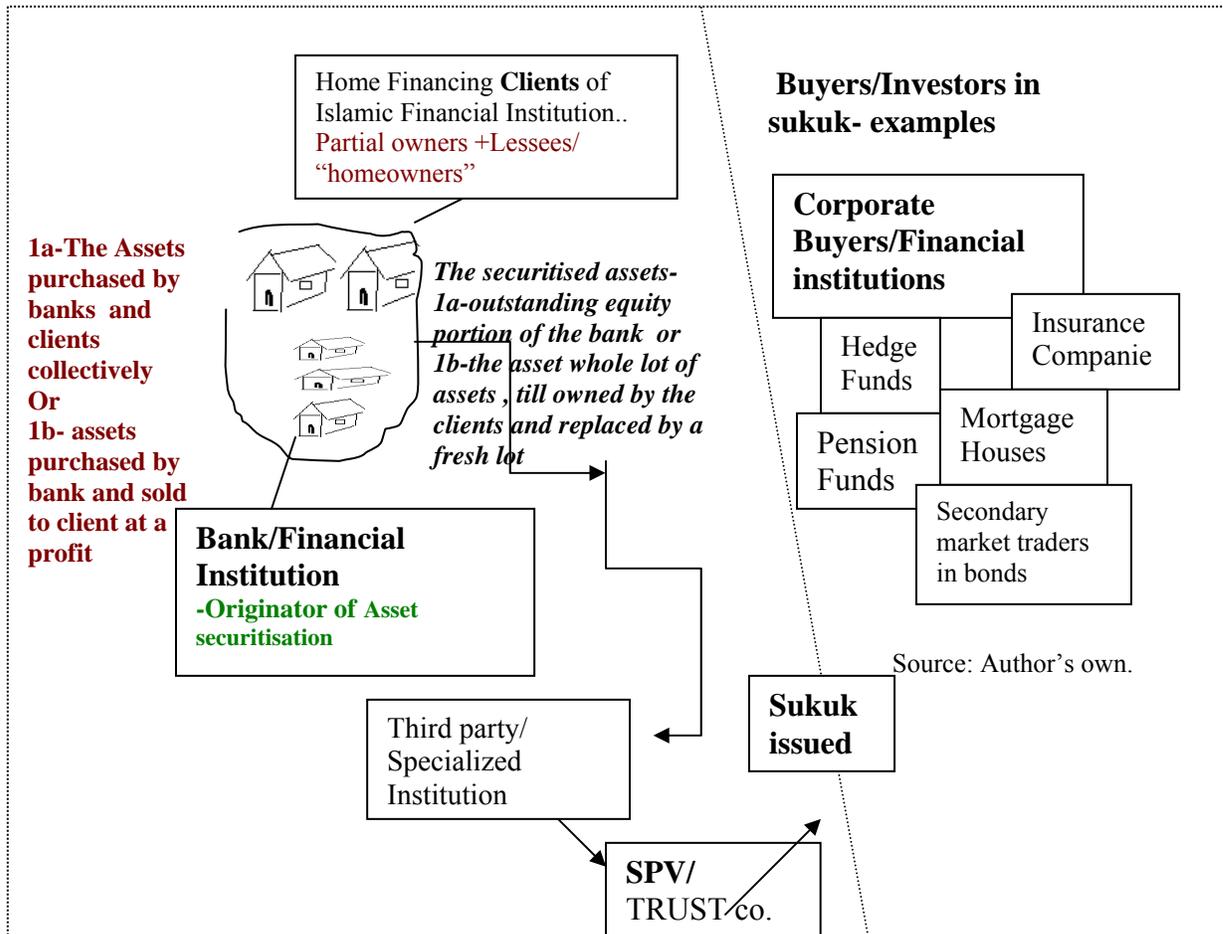
¹⁰⁷ Sometimes the client has purchased the land (plot) at a given market value and then the bank becomes a partner in the property by helping finance the construction of the house

the customer. As soon as the customer pays a certain portion of the principal, the rent sharing proportion between the bank and customer changes accordingly. Hence the bank's proportion in the property diminishes as the customer pays back the principal and finally the customer fully owns the house¹⁰⁸. The bank's constructive title to physical assets (bank's portion of the investment) comprises the bank's equity portion. This can be securitised. The diminishing Musharakah contract also derives rent revenue from the underlying property. If a sukuk comprises only the diminishing Musharakah assets owned by the bank, the sukuk securities holders can be paid their periodic returns from the rent revenue¹⁰⁹. As the equity balance of the bank reduces, fresh contracts can fill the gap, in the securitised assets balance to give it continuity, until the sukuk matures.

¹⁰⁸ To mitigate risk further, the house (asset) is mortgaged with the bank /or the documents of the asset held with the bank). This type of diminishing Musharakah as a product of house financing is being practiced by Meezan Bank Limited¹⁰⁸, a fully Islamic bank incorporated in Pakistan

¹⁰⁹ The rent too, shall preferably, be based on the market rents for such property and not based on money market rates, to conform to the Sharia's objectives.

Figure 4.5
Sukuk Securitisation structure (as a facilitator of Islamic banking)



“Sukuk as an Asset Securitisation Instrument and its relevance for banks”, Review of Islamic Economics, Volume 12, No. 1, 2008

Under arrangement 1b, which is Murabaha financing, and being practiced by “Manzil” home financing scheme in the U.K, the bank purchases the property and re-sells it to the client at a profit margin. The customer usually pays a certain portion of the property cost upfront and the rest is paid in installments. If (and only if) the outstanding amount represents the bank’s ownership in the property, that portion of the property can likewise be securitised through sukuk as in the case of diminishing Musharakah above and the securities pool replenished

with fresh assets as the previous ones get paid out. However, it must be understood that if the murabaha is such that the whole property is sold to the bank's customer and then the customer makes deferred payments, that deferred payments represent debt and cannot be securitised for the purpose of making investment gains as sale of debt can only be at par and the debt remains as debt till it is paid. Hence, jurists have objected to securitizing deferred (payments in) Murabaha as part of the bank's portfolio of assets¹¹⁰. According to AAOIFI's definition of Murabaha sukuk (Sharia'h Standard No. 17, 5/1/5/5, p.302.) the underlying asset i.e. the murabaha commodities in the ownership of the issuer (bank in our case) can be sold to the sukuk subscribers. The realized funds become the purchasing cost of the commodities, while the sukuk holders are entitled to the sale price from the Murabaha sale of the commodities. In other words, it means that goods meant for Murabaha sale, shall be sold/securitised in the form of sukuk and then the sukuk holders become owners of the goods, while the bank on behalf of the sukuk holders, or Issuer SPV, executes a Murabaha or a deferred Murabaha contract with the bank's customers for the Murabaha. The same principle can be used by the U.K banks' "Manzil" program for housing facilitation.

Outstanding contracts of Istisna'a appearing as prepayments in bank's assets cannot be securitised. Only when delivery of the goods is made in Istisna'a, the goods received can be securitised. In addition, apart from the banking business, a manufacturer of the goods can securitize the goods by selling them to the sukuk investors in that Istisna'a sukuk. The sukuk investors are then entitled to the sale price received. Hence, like traditional and synthetic

¹¹⁰ Likewise outstanding istisna'a contracts cannot be securitised.

securitisations taking many forms and shapes according to the market demand and the legal requirements, there can many different types of sukuk securitisations.

To sum up, banking transactions involving equity participation, and sale of assets and/or use of assets (Ijara'h) can be securitised as they involve sale of real assets and profit from the sale or rent from the Ijara'h (Lease). Composite Asset portfolios with a majority of Ijara'h and Musharaka transactions are allowed for securitisation by the Sharia'h rulings. Deferred payments outstanding from sale of assets or their use (usufruct) represent an account receivable which is a financial transaction only, in the absence of the underlying assets. These deferred payments, without the underlying assets cannot be sold at a better rate to the SPV (issuer) for onward issuance of sukuk and are "*haram*" or impermissible as earning from the transaction is interest¹¹¹. In addition, banks ought to securitize their assets through legally independent third parties or to sukuk holders (when true sales take place) in order to alienate the securitised sukuk assets from other bank assets. In principle, the Sharia'h allows securitization involving real assets and equity participation of the banks.

Islamic banks need the utility of sukuk securitisation, owing to the real assets that they have to carry at residual book value on their balance sheets for long durations, due to transactions like Ijara'h, and Diminishing Musharakah home financing. The real assets can be sold to investors including institutional investors, hedge funds, insurance or takaful (Islamic co-operative insurance) companies and others. The most common type of sukuk form in use is Ijara'h sukuk¹¹².

¹¹¹ as it defeats the Islamic validity of the transaction

¹¹² It usually has a floating rate of return due to the adjustable rate of return in the rent on the underlying ijarah assets. Examples of Ijara'h Sukuk include The Government of Pakistan's sukuk for its motorway project in February 2005, The Government of Qatar's sukuk besides many others. The Solidarity Trust Sukuk (2003) by The Islamic Development Bank is an example of a composite sukuk with a majority of Ijara'h contracts but also containing murabaha and Iistisna'a transactions.

4.7.3.1.4 Other Considerations in sukuk securitisation

The likelihood for a bank to sell good quality assets and retain poor quality assets in a given regulatory band for capital requirement should also be curbed through proper supervision /regulations. Otherwise, securitisation, (and sukuk securitisation) would have a negative impact on the asset quality and increase risk and resultant systemic risk too. On the other hand, if the same asset portfolio, is sold at a higher price than its original cost to the bank and the original cost to the purchaser of the assets, somebody (which can be depositors, or tax payers) is paying the cost of securitisation, upfront or in the future, unless the securitisation is used as a tool to hedge (neutralize, reduce) some risk of the recipient (of returns from the securitisation/sukuk/bonds). For sukuk to become more practical and sustainable for financial institutions, the cost of securitisation should not exceed the cost of deposits, the traditional source of funding for banks.

If a portion of the asset portfolio of the bank is sold (securitised), this securitisation can disseminate the portfolio risk to other participants in the transactions and across different markets and participants. However, other permissible mechanisms of credit enhancements can be utilized, instead of guarantees provided by originators to make the risk dissemination more effective¹¹³. It would be necessary for regulators to devise regulations to safeguard the interests of depositors (or taxpayers) as stakeholders who do not have a collective voice and cannot influence the investment decisions of the bank/s (or country, for taxpayers).

¹¹³ As in some securitisation contracts for sukuk as well as the traditional and synthetic securitisations, if the originator bank is providing guarantees, to the SPV / trust Co for ensuring timely payment of the returns to the bond/sukuk –holders, this can enhance the credit worthiness of the issue but on the other hand, it is putting unnecessary risk, back on the originator. To me this defeats the purpose of a sale. This kind of issue is like a guaranteed loan and should call for a creation of provision against such guarantees.

If in any case the securitisation issue goes into problems, regarding payments to investors from the returns from the underlying assets, with a sovereign guarantee, the tax-payers pay, and with the bank guarantee, it is the ordinary depositors, who bear the brunt of failed projects.

According to the AAOIFI Sharia’h standards for Sukuk (i.e. Investment Sukuk) the sukuk ought to be based primarily on combination of equity stakes, instead of debt. They should be structured in a Sharia’h permissible way and their underlying assets should also be Sharia’h permissible. For example, the underlying assets whose usage rights have been sold in Ijara’h sukuk were Hydel Turbines in WAPDA sukuk, auto vehicles in Caravan 1 sukuk, cooling plants were the underlying assets in Tabreed Sukuk, and plantation (land) in Guthrie sukuk. Having built the case for need of securitization for Islamic financial institutions and the Sharia’h views on sale of various types of transaction we, shall depict the commonalities and differences between sukuk and conventional securitization in the table given below. The main features of the sukuk are based on the explanations above and are in accordance with the AAOIFI Sharia’h Standards and their securitization properties.

Table 4.4
Testing Hypothesis II

Comparing AAOIFI’s Sukuk and Conventional securitization			
		AAOIFI’s Sukuk	Conventional securitization
1.	Asset-backed	Yes	Not necessary
2.	Money/debt as asset	¹¹⁴ No	Yes
3.	Debt can be sold at a discount	No	Yes

¹¹⁴ Money is not considered as a commodity asset in Islamic finance and cannot be the reason for earning a return, until it shares the profit and loss as in equity contributions

4.	Credit can be securitized	No, Only underlying asset owned by the originator can be securitized	Yes, at an agreed price
5.	Credit tranching	No (unfair transaction)	Yes
6.	Improves Balance sheet efficiency ¹¹⁵	Yes	Yes

Table 4.4 above gives a point-wise comparison of sukuk and conventional securitization. The main difference between sukuk (as depicted by AAOIFI Sharia'h Standards) and conventional securitization lies in the necessary condition of asset backed or asset –based nature of sukuk to remain Islamic instruments. The term asset-backed securities used in conventional structured finance above, is different from that of Islamic finance. In Islamic Finance, money is not considered as a commodity asset. By asset, Islamic finance means a commodity asset. In addition, debt cannot be traded, by “adding” value, in the conventional sense. A debt is taken as “frozen value”. Any addition charged on debt is considered as *riba* and hence an impermissible transaction in Sharia'h. Similarly, tranching of a pool of assets that gives unequal rights to risk and return is leading to an unfair business, and hence should be impermissible. Since sale of credit i.e. debt is unlawful and impermissible at any value , other than par value of the debt, credit tranching in conventional securitization does not apply

¹¹⁵ It means that this transaction can improve efficiency of Financial Institution from Balance Sheet perspective, as explained earlier in Section III.

to sukuk. Likewise, the AAOIFI has not discussed credit tranching in its Sharia'h Standards for the Investment sukuk. However, for the sake of further clarity it is discussed as follows. Since it leads to an unfair deal, considering different risk levels and different returns to investors of various credit classes, it is inferred from Sharia'h principles that credit tranching is impermissible in sukuk. It is hoped that this explanation should serve as a check on any backdoors to credit tranching, if any discussion or possibility arises in future.

Sukuk and conventional securitization share the common element of improving the efficiency of the originating financial institutions by improving their balance sheet position, off-loading the securitized assets to investors who buy their asset-backed securities and in return pay the financial institutions, upfront. This provides the much needed liquidity to financial institutions, especially in the case of Islamic financial institutions which deal with real tangible assets. This analysis establishes the case for sukuk as securitization instrument in Islamic finance and at the same time proves that sukuk, as depicted by the AAOIFI Sharia Standards, are different from conventional securitization. Yet they can be used as (Islamically permissible) securitization tools for improving the efficiency of the Islamic financial Institutions.

4.7.4 Conclusion – Securitisation and sukuk

Asset securitisation is an effective tool in making use of otherwise immovable and illiquid assets and getting direct funding from the investors. Sukuk represent an asset securitisation form distinguished primarily on the basis of two features. They are based on (sale of) real assets or their usage as underlying assets. In complying with the Sharia'h requirements, they

are devoid of interest and ought to function on the basis of profit or loss from a sale /purchase.

The tool of asset securitisation is very popularly used in the western countries since the late eighties. Sukuk (the Islamic mode of securitisation) have emerged rather recently with their international debut in 2002. They quickly gained momentum and are now being extensively used by corporate, and government entities to raise funds for their projects and assets directly from the bond market. Islamic financial institutions have made recent entries in the sukuk market. They particularly need the utility of sukuk to securitize their assets, owing to the real assets they carry on the books. Using Sukuk product structures, the financial institutions can generate fresh funds and revamp their portfolios while following the Islamic Sharia'h rulings in addition to the banking regulations. The future usage of sukuk by Islamic banks is very promising as their sphere of activities expands and their appetite for funding increases. Sukuk can supplement deposits. Along with Asset-backed sukuk, their application in raising funds for project finance plus invention of convertible/exchangeable sukuk should be in the offing. Proper management and regulation of sukuk can help in risk diversification without detriment to the rights of the depositors.

SECTION IV

4.8 Sukuk for Financial Institutions-Regulatory Perspective

In the preceding sections, we have so far presented a synthesis of the sukuk in terms of the AAOIFI Sharia'h Standards in the form of Hypothesis I. Further, the position of AAOIFI's sukuk for securitisation in comparison with conventional securitisation has been clarified in Hypothesis II. This section further undertakes a view of the sukuk for Islamic Financial Institutions through a purely regulatory perspective, utilizing the Basel II securitization framework of credit risk.. This regulatory perspective is utilized for understanding the true nature or economic substance of sukuk for its risk sharing or transfer attributes and subsequent possibility of risk weighting concessions in capital for Islamic Financial Institutions as originators of sukuk. This in essence represents Hypothesis III and IV respectively. Taken together, they underpin the AAOIFI-subscribed Sukuk's utility for Islamic Financial Institutions, in improving their capital adequacy position. In other words, Hypothesis III and IV tests, utilizes the securitization framework of credit risk of Basel II regulations in gauging the risk-based capital adequacy requirements for sukuk securitisation in Islamic Financial Institutions. This analysis shall further establish the validity of Hypothesis I or lack of it as the actual impact and substance of sukuk contracts becomes further clear. For example, if it turns out to be lacking sharing of risk and reward according to the basic rules of the contracts, and instead conforms to the conventional practice, based on pre-determined rewards and severed and alienated risk, then this information shall be very useful.

Taking the cue from Basel II, the current research analyses the Solidarity Trust Certificates sukuk issue of 12th February 2003, originated by IDB for their economic substance and their underlying risk and return profile, in order to know whether the sukuk enable risk transformation from the originator to the sukuk holders, which should be obtained for transactions that involve sale as well as those that comprise profit and loss sharing among partners in capital contribution. Such sale transactions and equity based partnerships qualify for obtaining a concessionary treatment in capital allocation. Through this mechanism of creation of sukuk, the bank is transferring ownership from itself to the SPV and eventually claims on the assets being held by the certificate holders through sukuk. This sukuk, in effect securitizes IDB assets. This sukuk (Solidarity Trust Certificates sukuk, 2003) has been described in detail in Chapter Four.

4.8.1 Testing Hypothesis No. III & IV

Hypothesis III and IV are grouped together for testing, explanations and conclusions as they are closely interrelated. They are both analyzing Sukuk from the perspective of the Basel II Securitization framework within the credit risk category. In fact the result for Hypothesis IV emanates from the result of Hypothesis III.

Hypothesis No. III: “Sukuk transfer risk from the originator to sukuk holders, which is Sharia compatible”

IFIs can issue sukuk for securitizing their assets and raising new funds. Regarding this hypothesis, the closest available proxy sukuk, the Solidarity Trust Services (STS) Sukuk (2003) issued by the Islamic Development Bank has been used. . The economic substance in its risk and return profile is analyzed in order to ascertain whether the sukuk transfers risk from the originator to the sukuk holders. Technically speaking, they should transfer risk if they are Sharia’h Compatible. However, as in conventional finance, especially with the advent of the concept of risk alienation from original contracts, even a contract of sale, may be so designed that the transfer of risk from the seller to the buyer may not be taking place. Another issue lies in the fact that the AAOIFI Sharia’h standards have not laid out a precise format of contracts or their sub components. Hence there are chances of practically digressing from what the Sharia’h i.e. AAOIFI prescribes. This can be checked by using another very important tool, which is the Basel II securitization framework. This framework has clauses that focus on the economic substance of the composite contracts of securitisation and any other derivative forms of transactions. Its seeks to find out where the risk of transactions lies, and to what extent is it reduced through risk transformation from one form

to another and from one entity to other third parties. In our case we apply the same clauses to find out about risk transfer or sharing and hence any reduction in risk borne by the sukuk originators.

Hypothesis No. IV:

“Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.”

Hypothesis IV goes further in giving a verdict whether the sukuk securitised assets can be excluded from risk-weighted assets for calculating the risk weighted assets according to Basel II. This result depends upon whether or not, risk is transferred from originator IFI to the sukuk holders or shared among the originator and sukuk holders (plus any third parties, if any) as Hypothesis III would have proved.

Hypotheses III and IV take the following attributes of the sukuk contracts into consideration and then answer the checklist of clauses provided by the Basel II securitization framework

1. The underlying contract , with returns pattern
2. Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.
3. Repurchase agreement to mitigate the risk of payment of principal.
4. The value or worth of any collateral in terms of market value
5. Any calls or put options embedded in the contract
6. The existence of amortization schedule for repayment of the obligations

The Basel II checklist for assessing risk transfer or reduction in sukuk contracts, based on their economic substance of the contract comprises the following:

1. Significant risk transfer from originator to the sukuk holders
2. No effective control of the transferor or its creditors on securitized assets

3. Issued securities not obligation of the transferor
4. Other clauses (SPE/SPV As Transferee – Amortization plan, clean –up call)
5. Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.
6. Repurchase agreement to mitigate the risk of payment of principal.
7. The value or worth of any collateral in terms of market value
8. omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality
9. Any calls or put options embedded in the contract

Basel II assesses product attributes and in the processes examines how and to what extent safeguards to the returns of the recipients and investors are in place. This is evident from points 2, 3, 4, 5 and 6 above. Points 1 and 5 are the core measures for risk transformation or risk transfer (as in our case), from the originator to the investors. In our analysis we use all the related clauses of the securitization framework in order to explain the composition of the sukuk and particularly use point 1 and 5 to further prove or disprove Hypothesis III and IV in terms of Basel II's risk transfer assessment and excluding sukuk securitized assets from risk weighted assets respectively.

This analysis shall clarify and prove whether or not risk transfer is taking place from the originator to the sukuk holders as in Hypothesis III. Based on the results from Hypothesis III, a similar exercise or a parallel exercise enables answer to the statement of Hypothesis IV. These qualifying points should show that if risk is getting transferred or reduced due to sharing with sukuk holders, then the Basel II framework should be able to recognize it and enable the IFI to have a lesser risk-weighted capital , by excluding the sukuk securitised

assets from risk weighted assets. However, if risk is not getting transferred or reduced, then Basel II assessment criteria shall not exclude the sukuk securitized from the risk weighted asset and hence would not provide for risk weighting concessions to the IFIs issuing sukuk. This is what Hypothesis IV assesses.

Table 4.5
Testing Hypothesis III

		Hypothesis No. III
Sukuk structure Sample=STS Sukuk	Characteristics Economic substance	Risk transfer from originator to sukuk holders
1.	Significant Risk transfer in Sukuk Underlying contract 1. the contract of sale, Ijara'h re sale 2. repurchase agreement 3. guarantee 4. triggering of dissolution event	No risk transfer Significant Risk transfer from IFI (originator) to sukuk holders (based on study of underlying contract/s) does not take place because of guarantee of returns and repurchase agreement.(given in No.5 & 6 below)
2	No effective control of the transferor or its creditors on securitised assets	N.A- This point not related to risk transfer , but emphasizes the independence of investors from any claims of the originator and its creditors in case of bankruptcy
3.	Issued Securities not obligation of transferor	Issued securities remain the obligation of transferor. Hence no risk transfer
4.	Other clauses (SPE/SPV As Transferee – Amortization plan, clean – up call.	N.A This clause is meant for the security of bond holders/sukuk holders to ensure that their payments are secure. Amortization plan is in place and guaranteed by originator. Dissolution event clause exists, which can be called by the SPV, and has to be

		honored by the originator.
5.	Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.	No risk transfer as given in No. 1 above Due to guarantee provided by the originator safeguarding the periodic returns and the final maturity value to the sukuk holders.
6	Repurchase agreement to mitigate the risk of payment of principal.	No risk transfer due to the repurchase agreement by the transferor with the investors.
7.	The value or worth of any collateral in terms of market value	Not applicable to risk transfer. The underlying assets are owned by the sukuk holders, instead of being held as collateral
8	omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality	No risk transfer. Risk exists for the originator in case the composition of the sukuk alters to a level that triggers dissolution event , whereby the originator has to honour the dissolution and pay the sukuk holders according to its terms ¹¹⁶
9.	Any calls or put options embedded in the contract	No risk transfer. The repurchase agreement and the dissolution clause cause risk to be vested in the originator. ¹¹⁷

¹¹⁶ The sukuk contract states that in the composition of the underlying asset contracts, the volume of Ijara'h contracts should not drop below 51%, at any point in time, failing which the dissolution event for sukuk will be triggered.

¹¹⁷ The repurchase agreement and the Dissolution Clause exist. The former limits the downside, in the value of the sukuk, by locking in the value of the underlying assets to be repurchased by the originator. The latter can be triggered if the composition of the sukuk changes to an extent that they become Sharia'h impermissible. In case of the former, the sukuk holders' loss is zero and profit is as agreed in the contract, over the original investment. In the latter, which is Sharia'hh compliance risk, the dissolution clause, requires sufficient liquidity of the originator, in case it happens. To the sukuk holders it implies exposure on the market potential of the products of the IFI. But its negative repercussion can only be felt by the originator, because of its guarantees. Makes the structure more robust than conventional securitisation bonds, in favour of the sukuk holders.

Table 4.6

Testing Hypothesis IV

			Hypothesis IV
			Excluding sukuk securitised assets from risk –weighted assets
Sukuk structure	Characteristics	<i>Hypothesis III</i>	
STS Sukuk	Risk mitigation or transfer		
1.	The sukuk underlying contract , with risk and returns pattern 1. the contract of sale, Ijara'h and re- sale 2. repurchase agreement 3. guarantee 4. triggering of dissolution event	<i>Significant Risk transfer does not take place</i>	Not excluded because Risk transfer or reduction has not taken place due to points No. 5 and 6, pertaining to guaranteed payment of principal and periodic payments and repurchase agreement to repurchase the assets at pre-agreed price.
2.	Issued Securities not obligation of transferor	<i>Obligation of transferor i.e. IFI</i>	Not excluded Differs from traditional conventional securitisation. Issued Securities remain obligation of transferor due to guarantee provided by the originator safeguarding the periodic returns and the final maturity value to the sukuk holders. The sukuk holders are secure, (except if the originator becomes bankrupt.)
3.	Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.	<i>Guarantee exists and causes lack of risk transfer from IFI</i>	Not excluded Due to guarantee provided by the originator safeguarding the periodic returns and the final maturity value to the sukuk holders. The sukuk holders are secure
4	Repurchase agreement to mitigate the risk of	<i>It exists and risk remains</i>	Not excluded. Repurchase agreement in the sukuk

	payment of principal.	<i>with IFI</i>	exists to mitigate the risk of payment of principal. The sukuk holders are secure in this regard
5	omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality	<i>Dissolution event. requires maintenance of composition of sukuk</i>	Not excluded. The sukuk contract states that in the composition of the underlying asset contracts, the volume of Ijara'h contracts should not drop below 51%, at any point in time, failing which the dissolution event for sukuk will be triggered.
6.	Any calls or put options embedded in the contract	<i>Dissolution Clause exists</i>	Not excluded The repurchase agreement and the Dissolution Clause exist. The former limits the downside, in the value of the sukuk, by locking in the value of the underlying assets to be repurchased by the originator. The latter can be triggered if the composition of the sukuk changes to an extent that they become Sharia'h impermissible. In case of the former, the sukuk holders' loss is zero and profit is as agreed in the contract, over the original investment. In the latter, which is Sharia'h compliance risk, the dissolution clause, requires sufficient liquidity of the originator, in case it happens. To the sukuk holders it implies exposure on the market potential of the products of the IFI. But its negative repercussion can only be felt by the originator, because of its guarantees. Makes the structure more robust than conventional securitisation bonds, in favour of the sukuk holders.

The above tables have been explained in detail below.

4.8.1.1 Explaining the test results- Hypothesis III

Analysis of STS Sukuk (2003) with the Securitisation Framework clauses of Basel II for risk transformation

Basel II's credit risk pillar assesses products for credit risk, which exists in the traditional products, due to their debt-based system of lending and borrowing. It assesses a product's risk mitigating attributes and if risk is totally or partially transferred from the Financial Institution (FI) to a third party, it gives an incentive of reduced regulatory capital requirement, based on magnitude of risk transformed or transfer (as may be in our case). This aspect of Basel II rewards the practice of risk –mitigation while trying to accurately assign and gauge the risk elements in the products. It aims at reducing the overall risk in the system through an incentive-based adequate buffer of capital base for FI. In securitisation transactions, Basel II specifically addresses the risk transformation (or transfer) aspect of the securitisation. At the same time it assesses the extent of safeguard of returns and principal available to the investors (i.e. buyers) of securitised positions, in order to protect their interests too. These form part of Basel II's operational risk requirement for traditional securitisation. For sukuk securitisations too, these clauses of Basel II were used to test the sukuk sample for its risk transformation attribute. The details of the test result are explained below.

4.8.1.1.2 Significant Risk transfer from IFI (originator) to third party

(a) “The conditions for excluding securitised assets from the calculations of risk weighted assets are that (a) significant credit risk associated with the securitised exposures has been transferred to third parties.” (Basel II, Securitization Framework in Credit Risk Pillar, 2004)

4.8.1.1.2.1 Analysis of the Sukuk's risk transfer to SPV and Trustee

In the case of sukuk samples studied, at least one SPV is created, to whom the underlying assets are transferred or sold. The SPV collects the subscription money from sukuk holders and pays the originator, i.e. the IFI. The whole exercise legally alienates the underlying assets from the possession of the originator, during the tenure of the sukuk. As a result of the sale transaction from IFI to SPV (as trustee of sukuk holders), transfer of ownership and hence transfer of risk from the underlying asset shall take place from the originator to sukuk holders who become the owners of the assets. In such a case of outright sale, according to Basel II's securitisation framework clauses, significant credit risk (in fact, all risk) gets transferred to the buyer of the securities, i.e. sukuk holders. This should have been the case in sukuk securitisation. However, upon study of the STS Sukuk prospectus in particular, the position is as follows:

Although sale of underlying assets takes place from the originator IFI to SPV (as Sukuk holders trustee or agent) and ownership gets transferred, this transfer of ownership is for a certain specified period of time due to other transactions and clauses embedded in the sukuk structure. These are as follows:

- a) the clause in the sukuk structure in which the IFI undertakes to repurchase the same assets at the end of the sukuk tenure at a pre agreed price which is the maturity value of the sukuk.
- b) the clause of undertaking by the IFI to guarantee the timely payment of periodic payment and principal amount.
- c) The role of the SPV in sukuk issuance is more of administrative and facilitative entity for the Islamic Financial requirement of sale /exchange of assets, with respect to investment instruments, so that it (the issuer of the investment certificates, i.e. the IFI) does not deal with

only documents but with real transfer of assets. It creates a separate legal entity which can own assets and sell or buy them too. Other than that the SPV does not buffer the credit risk in any case. Being 100% owned by the originator, it serves as a conduit or channel for issuing sukuk and raising funds from them for the originator. The same or another SPV serves as trustee of the sukuk. On the contrary, the conventional “traditional” securitisation which are backed by assets of any kind, the underlying assets are backing the bonds issue and there is no repurchase agreement of the sort mentioned in sukuk issue, once the pricing and costing of the deal/s is effected, although that pricing mechanism is all *riba*-based. They have built in the price, all related factors, like price escalation of the underlying assets or of the projects’ cash flow deviation from the estimates. The concerned parties have negotiated the terms at the commencement of the contract. It means that once the deal takes place and the “price of debt is paid or set aside”, there are no further guarantees in the form of contingent claims to meet, unless the government or a government sponsored agency as SPV, explicitly or implicitly guarantees the issue. In such a situation, there can be the verdict that significant risk has been transferred to an independent SPV or another guarantor (which is the government or a government sponsored SPV).

Hence in the sukuk under consideration, and all such sukuk who have the same or similar features, significant risk is still vested in the originator of the transaction, even in the case of sovereigns as originators. Therefore, the securitised assets in such sukuk (originated by banks) would not qualify for being excluded from calculation of risk-weighted assets for these banks.

4.8.1.1.3 No Effective Control of Transferor

This condition is meant to ensure the bankruptcy remoteness of the underlying assets from the hold of the originator and its creditors, in case the originator goes bankrupt. This clause is meant to safeguard the securities holders.

According to this clause in the securitisation framework, no effective or indirect control¹¹⁸ of the transferor (and its creditors), should exist on the securitised assets and the securitised assets need to be legally separate e.g. through assets' sale or through sub participation in which the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership.

4.8.1.1.3.1 Effective control of the transferor in Sukuk

After studying the legal documents of the sukuk, the conclusion reached is that the transferor, which is the originator, and in some cases, the SPV too as the secondary transferor¹¹⁹, does not maintain an effective or indirect control over the transferred exposures, except as an agent of the sukuk holders or the SPV, in order to service the underlying assets, due to their expert know-how in the field of intermediation and their knowledge about the clients. Hence, like conventional securitisation, legally speaking the transferor or originator does not hold any effective control over the securitised assets. However, if you study the repurchase agreement and the lease to the originator, the asset remains with the transferor and at the end

¹¹⁸ The securitisation framework explains effective control of the assets (for credit risk exposures) by the transferor “if it: (i) is able to repurchase from the transferee the previously transferred exposures in order to realize their benefits; or (ii) is obligated to retain the risk of the transferred exposures. The transferor’s retention of servicing rights to the exposures will not necessarily constitute indirect control of the exposures.”. Source: The International Convergence of Capital Measurement and Capital Standards” report (Basel II)

¹¹⁹ when the issuer is another entity created as issuer of the trust certificates /sukuk and also acts as trustee of the certificate holders

of the sukuk period, goes back to the originator at a pre-agreed price. In addition, the originator's liability vis-a-vis the SPV and the trust company and the certificate holders still exists, like the lender of last resort function. Hence looking at the sukuk contracts from beginning to the end, the answer to this clause is both yes , no effective control exists legally from the transferor over the securitised assets , and also no the asset lies with the originator albeit as a lessee and also goes to it finally in the end when it re purchases it.

The crux of the issue is that the certificate holders are made secure and they do not have the fear of liquidation or charge (claim) on the underlying assets from the creditors of the transferor/s but the transferor (especially the originator) is not "free" from any liabilities and contingencies.

4.8.1.1.3 Issued Securities not obligation of transferor

Point # c of the securitisation framework of Basel II credit risk category, has the condition that the securities issued should not be the obligations of the transferor and therefore the investors in the securities have only claim to the underlying pool of exposures and not to the whole bank.

In the case of sukuk, the securities are indirectly the obligation of the transferor or originator although the investors own the underlying assets. In addition, in the Ijara'h contract, with the originator IFI as the lessee, the sukuk holders have claim to the extent of the periodic payments and the dissolution amount or maturity amount whatever the case may be. The claim is not limited to the underlying pool of exposure since the sukuk holders own the underlying pool but it is on the entire bank due to the guarantees provided by the bank (as explained earlier).

4.8.1.1.4 Other clauses (SPE as Transferee – Amortization plan)

(d) The SPE is described as the transferee and the necessity of exchange, transferability or pledge of the beneficial interests in the SPE without restriction is required along with the requirements of clean-up calls in the securitisation. Basel II allows certain relaxations (i.e. no capital required) if certain clean-up calls with necessary required conditions are met.

(e) Similarly, for qualifying for the benefits of having “a controlled amortization plan” in place, the bank should have a liquidity plan in place to meet early amortization and should have the feature of “the pro rata sharing of interest, principal, expenses, losses and recoveries”

If we examine the IDB Sukuk Structures, regarding point (d) above, the SPE does enjoy the privileged rights mentioned. Similarly regarding point (e) the liquidity plan according to the amortization schedule is a general practice and “has to be” in place because of the contracts requirements (although not mentioned in the prospectus) but any clause of “ pro-rata sharing of interest , principal,....” with the sukuk holders as required by the AAOIFI Sharia’h Standards is not there. There is an earlier clean-up call in the shape of a dissolution event which can be triggered due to the inappropriate composition of the sukuk assets. It can also be called a Sharia’h compliance risk factor clause. In case such a dissolution clause gets revoked, the responsibility of paying the outstanding dues lies with the bank as originator, according to the legal document of the sukuk transaction.¹²⁰ Therefore, with the conditions (d) and (e) being met as in debt-based securitisation but in a different manner, it is unclear whether the IDB sukuk qualifies for the benefits of a controlled amortization plan in place.

¹²⁰ Besides, periodic payments of returns to sukuk holders are based on predetermined rates which may be fixed or floating rates, usually attached to LIBOR.

Another important point (f)¹²¹ pertains to the omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality. The securitisation does require the bank (originator) to ensure that in the composition of the underlying asset contracts, the volume of Ijara'h contracts does not drop below a certain specified percentage (majority amount), at any point in time, failing which the dissolution event for sukuk will be triggered. There is no other clean-up call embedded in the sukuk transaction¹²².

IDB (the originating bank) is also required to provide temporary liquidity to the SPV for making periodic payments, free of cost (interest) between the tranches of payments. The SPV is to repay the loaned amount before the next tranche, or as soon as possible.

4.8.1.2 Explaining results of Hypothesis IV: Excluding securitised Assets from risk-weighted assets

The concession of excluding securitised assets from risk-weighted assets means that unless it is proven that certain features exist in the assets, due to which the risk (and title/ownership) from securitised assets is shifted to buyers or third parties other than the originator or its subsidiaries, the securitised assets cannot be considered to be out of the balance sheet, or a certain proportion of their risk would be still vested in the originator, due to which the securitised assets shall be included as part of the financial institutions' risk-weighted assets. The risk from securitised assets can be transferred from the originator to the

121 The securitisation does not contain clauses that (i) require the originating bank to alter systematically the underlying exposures such that the pool's weighted average credit quality is improved unless this is achieved by selling assets to independent and unaffiliated third parties at market prices; (ii) allow for increases in a retained first loss position or credit enhancement provided by the originating bank after the transaction's inception; or (iii) increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool."

¹²² Excess spread and implicit support needs to be ascertained, in individual sukuk transactions and its exposure determined accordingly.

third parties or buyers, if it is a true sale accompanying transfer of ownership. In addition if we consider a debt-based transaction in conventional finance, such that, third party/ies undertake to bear part or all of the risk of return or repayment and principal, in the form of a performance guarantee or writing an option, then the proportion of the securitized assets shall be reduced or excluded (if all risk is transferred) as per the Basel II reduced risk weights.. Hence the buffer minimum capital requirement for the issuer /originator IFI would reduce in our case of the sukuk, if the risk in securitised assets is shared with third parties or with the sukuk holders. In terms of interpretation from Islamic financial perspective, the owners of assets or projects share their risk and rewards among themselves, and their risk is therefore based on the proportion of sharing of risk among them. If any assets are securitised, by selling them to third parties in the form of sukuk, then according to the Islamic contracts' principles, the ownership as well as the risk from those sold assets get transferred or sold off as part of the sale. In such a case, it would be natural to expect that the securitised assets comprising the underlying assets of sukuk shall be excluded from the calculation of risk-weighted capital.

4.8.2 Conclusion- Hypothesis III and IV

We conclude from application and analysis using Hypothesis III that risk transfer (or reduction) from originator to sukuk holders or any other third parties does not takes place in sukuk securitisation. Hypothesis IV assesses whether sukuk originating IFIs shall qualify for risk weighting concessions in their capital adequacy assessment according to the Basel II incentive scheme. If risk from the underlying sukuk transaction was getting transferred or

reduced (mitigated) from the originator IFI (the crux of Hypothesis III), they (IFIs) would have benefited accordingly. However, the position is the following:

Sukuk is not very different from traditional conventional securitisation in structure, except for the usage of underlying assets or projects (as proved in Hypothesis II). The sukuk under study contains all the necessary clauses required for traditional securitisation, except for its asset-backed nature.

The risk from the underlying transactions remains with the Sukuk originators, as they guarantee the repurchase price on maturity of the contract, and provide regular periodic payments on leased assets in Ijara'h Sukuk.

In Musharakah Sukuk, the redemption price is pre-agreed instead of a market price at the time of redemption. In addition, conversion rate for converting Sukuk to shares at call time is also pre-agreed. Should the market price be different from the prices agreed, the originators shall be bound by the prices agreed. Although the originators limit their downside risk in this manner, they leave open their upside risk.

Hence we deduce that since risk is not transferred from the originator to the Sukuk holders (Hypothesis III), the Basel II's risk weighting concessions for minimum capital requirement do not apply to the financial institutions issuing (originating) Sukuk (Hypothesis IV).

It must be noted that this result does not mean that the AAOIFI Sharia'h Standards for sukuk advocate this shape of the sukuk or that they have designed the given structure of the sukuk in practice. In fact, Hypotheses III and IV also refute the claim that sukuk are exactly Sharia'h (i.e.)/ AAOIFI compliant. In addition, Hypothesis II gives a view of an AAOIFI prescribed sukuk as a securitization structure and its utility for Islamic financial institutions.

Chapter 5

Conclusions and Recommendations

5.1 Results of the Hypotheses

This research was carried out mainly with testing four inter-related hypotheses. .These hypotheses were as follows:

Hypothesis I:

Sukuk conform to the principles of Sharia'h

Hypothesis II:

“Sukuk are based on different securitization than that adopted in conventional instruments”

Hypothesis III

In Sukuk, risk is transferred from originators to sukuk holders, which is Sharia'h compatible

Hypothesis IV:

Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.

The results of the hypotheses are given below.

Hypothesis No 1: The Ijara'h Sukuk and Musharakah Sukuk samples were tested for

Hypothesis 1. The contract of Ijara'h was tested for the following attributes.

1. The underlying asset
2. The contract of Ijara'h
3. The contract of sale and lease back

4. Distribution of rent Return from originator to SPV and ultimately to sukuk holders
5. Distribution of loss, if any, from the Ijara'h transaction
6. The distribution of profit and loss from sale and resale, among the buyers and sellers, i.e. Originator, SPV, sukuk holders.

The results of hypothesis 1, showed that Ijara'h sukuk were compatible with AAOIFI Sharia'h standards in the following areas:

1. The (existence of) underlying assets
2. The contract of Ijara'h
3. The (existence of) contract of sale and lease back

They were not quite compatible in the following areas:

4. Distribution of rent return from originator to SPV and ultimately to sukuk holders
5. Distribution of loss, if any, from the Ijara'h transaction
6. The distribution of profit and loss from sale and resale, among the buyers and sellers, i.e. Originator, SPV, sukuk holders.

The above points 4 to 6 are the grey areas which needed further rectification. These are explained as follows:

1. Regarding the above mentioned point no. 5, according to the AAOIFI rules for underlying Ijara'h contracts, the risk of any loss or delay in returns of the Ijara'h rental is to be borne by the lessors. The Sukuk lease contract entails receipt of periodic rent by the lessors .i.e. sukuk holders. However, the lessors' risk element in Ijara'h rent gets overruled due to the guarantee provided by the originator (lessee) regarding the timely payment of lease installments to the lessors i.e. the

sukuk holders, throughout the tenure of the lease contract and the sukuk. In addition, the final payment to repurchase the leased asset is also secured through the repurchase agreement made by the originator (lessee) at a predetermined price. In totality, this kind of structuring defeats the spirit of the Ijara'h contract, which is simply renting out assets for a consideration. If due to any reason, a lessee or a tenant wants to stop using and leasing the asset before the expiry of the contract period, it can do so, upon giving a notice and there may be a small penalty charge for this purpose, but no more.

2. The attribute No. 3. is actually a sale leaseback and resale contract but the resale component has not been mentioned in any Ijara'h sukuk or in the AAOIFI Sharia'h Standards. However, the Ijara'h sukuk is a contract comprising sale, leaseback and resale. Regarding sale and resale contracts, if the transactions are analysed separately, they seem to comply with the rules of permissibility for sale contracts. However, if the sale and resale are understood to be taking place as part of the overall sukuk contract, it is clear that the originator is selling the assets to the sukuk holders through the SPV, and by the end of the tenure of the sukuk contract, the originator is going to purchase the assets back, at a pre-agreed price which comprises the maturity value of the sukuk. Sharia'h does not allow this practice of repurchase at a pre-agreed price, under Ijara'h contract. Practically, it means that the principal investment of the sukuk holders is made secure, through the undertaking of the originator to repurchase the sukuk underlying assets at the agreed price at the time of initial sale and commencement of the sukuk contract. If the contract is to remain as Sharia'h permissible, it is advisable to let the price of

resale be determined at the time of resale, based on market forces, and to let other bidders take part in the offer for sale and purchase.

3. Overall in the sukuk under discussion, the risk of loss in sale and leaseback combination lies with the originator, who is the seller, lessee, as well as repurchaser. This practice is not Sharia'h complaint. The guarantee and the repurchase agreement by the originator are the reasons behind this distortion. In the part of sukuk, comprising Ijara'h contract, technically speaking there is no loss in terms of agreed rent receivable by the sukuk holders and the rent to be paid by the lessee, unless, of course the originator defaults. However, the Sharia'h overrules, any guarantee of returns or principal to be provided by any of the parties to the contract to any one of them. (AAOIFI, 2003-4). This Ijara'h sukuk is not even a pure Ijara'h contract, but a sale plus Ijara'h plus resale contract between the same entities, and falls into the domain of "Iynah". The contract is designed in a manner that the originator is guaranteeing the returns and the principal investment, which is a violation of the Sharia'h principles.
6. The SPV does not incur any loss or profit as it generally serves as an agent fully owned by the originator or partially owned by the originator and other entities. The profit or loss, if any, actually accrues to the owners of SPV. Following market dynamics, technically speaking, and also from the point of view of Sharia'h, a loss or profit can occur and the by the sukuk holders being the owners of the underlying business and /or underlying assets, should be bearing a loss or getting a profit.

7. It must be noted that the main exposure of sukuk holders is on the originator of the sukuk. Hence it can be seen that sovereign sukuk of similar structures are priced according to their own sovereign risk factors (sovereign ratings internationally). Therefore, we see, LIBOR plus 0.95 for Malaysian Global (*Ijara'h*) sukuk (2002), LIBOR plus 0.5 for Qatar's Global (*Ijara'h*) Sukuk (2003) and LIBOR plus 2.2 for Pakistan's Global (*Ijara'h*) Sukuk (2005).

The Musharakah sukuk were analyzed next for testing Hypothesis I. They were tested for the following main attributes:

1. The underlying assets
2. The contract of Musharakah
3. Distribution mechanism :Profit sharing and loss Loss/distribution in Musharakah contract with originator, SPV and sukuk holders
4. Guarantees
5. Repurchase Agreement and /or redemption price

The AAOIFI Sharia'h Standard No. 17 describes a Musharakah sukuk as “certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares, with the Musharaka certificates being managed on the basis of participation or Mudaraba or an investment agency.”

According to the Hypothesis I test applied to the Musharakah sukuk, these sukuk complied with AAOIFI Sharia'h guidelines regarding points 1 and partly point 2. The underlying asset or project existed in the Musharakah sukuk, and was under the proportionate ownership of the originator and the sukuk holders through the SPV. However, regarding point No. 2, the contract of Musharakah was not according to the AAOIFI guidelines for Musharakah agreements. Instead, according to the terms of the Musharakah sukuk samples, the sukuk holders were given a fixed rate of return periodically, and a final redemption value of the sukuk with an option to convert the sukuk into shares at a pre- determined rate. Both rates

offered were fixed and pre-determined. Hence this method of distributing fixed return per investment to sukuk holders is in direct conflict with the Sharia'h principles and the AAOIFI Musharakah sukuk principles. The SPV is made a partner in the profit distribution but if the SPV is the representative of the sukuk holders, why is it that the sukuk holders are not distributed profit and loss according to the rules of Musharakah, which are pro rata sharing of losses and sharing of profits according to the agreed percent per investment share. Similarly a pre agreed conversion or redemption price as the case may be, instead of a market price at the time of subscription means a fixed predetermined price of the Sukuk conversion and is akin to guaranteed capital value of the Sukuk investment. This too is in clear violation to the Sharia'h principles for Musharaka and the AAOIFI Sharia'h Standards for Musharaka Sukuk. AAOIFI Sharia'h Standards which have clearly designated Sukuk as Investment Sukuk for clearly distinguishing them from stocks and bonds.(AAOIFI Sharia'h Standards,2003-4, p .298), do not have any requirement of a guarantee of periodic returns or principal to the any type of Sukuk holders. Hence, any guaranteed returns or guaranteed maturity value is contrary to the AAOIFI guidelines and the principles of Sharia'h. In addition AAOIFI has recently added ¹²³ its viewpoint on the matter as follows:

“2/2/1 The prohibition against seeking a guarantee in trust contracts is more stringent in Musharaka and Mudaraba contracts, since it is not permitted to require from a manager in the Mudaraba or the Musharaka contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment

¹²³ http://www.aaofi.com/aaofi_sb_sukuk_Feb2008_Eng.pdf

5.1.1 Hypothesis 1 results' summary

Hypothesis 1: Sukuk conform to the principles of Sharia'h

Hypothesis 1 was applied to representative samples of Ijara'h sukuk and Musharakah sukuk. The results for Hypothesis 1 for Ijara'h sukuk are that they partly conform but do not conform fully to the AAOIFI Sharia'h standards, although the sale and lease back contract is prescribed by the AAOIFI Sharia'h Standards. The results for Hypothesis 1 for Musharakah sukuk are that Musharakah Sukuk primarily do not conform to the AAOIFI Sharia'h standards as the underlying contract is not a Musharakah based contract and there is no risk and reward sharing between the originator and the sukuk holders according to the principles of Musharakah.

Hence Hypothesis 1 is partially true for Ijara'h sukuk and False for Musharakah sukuk.

5.1.2 Hypothesis 2 results' summary

Hypothesis II states, "Sukuk are asset securitization instruments".

To assess whether sukuk have asset securitization attributes , the AAOIFI description of the sukuk was analyzed for conventional asset securitization attributes, some of which are not Sharia'h compliant and *ribawi*.

The attributes for comparison of sukuk with asset securitization were:

1. Asset-backed
2. Money/debt as asset
3. Debt can be sold at a discount
4. Credit can be securitized
5. Credit tranching

6. The transaction improves efficiency of Financial Institution from Balance sheet perspective.

It was seen that the AAOIFI described sukuk are asset-backed but money or debt can neither form its underlying assets nor can be sold at a value other than par. Besides the exchange of money and debt, if at all, can only be hand –to-hand. Credit amount cannot be securitized but the underlying assets can be securitized. Similarly, credit tranching is not permissible, as it is exploitative, by allowing one tranche a preference in returns and lesser risk as compared to others. However, sukuk securitization, by securitizing the underlying assets representing the transactions and in the ownership of the financial institution, enhances the efficiency of the financial institution. Hence, sukuk are securitization instruments and can be used for securitization of asset portfolios of Islamic financial institutions, which would help in improving the efficiency of the financial institutions. However, they are unlike the conventional securitization in terms of points No. 2, 3, 4 and 5.

5.1.3 Hypothesis III results' summary

According to Hypothesis III, “Sukuk transfer risk from the originator to sukuk holders, which is Sharia'h compatible”.

The Sukuk sample was tested for the following attributes, according to the securitisation framework clauses of Credit risk category of Basel II:

1. Significant Risk transfer from IFI (originator) to third party (based on study of underlying contract/s)
2. No effective control of the transferor or its creditors on securitised assets

3. Issued Securities not obligation of transferor
4. Other clauses (SPE/SPV as Transferee – Amortization plan, clean –up call.
5. Any guarantee and the effectiveness of the guarantee in safeguarding the periodic returns and maturity value of the financial contracts.
6. Repurchase agreement to mitigate the risk of payment of principal.
7. The value or worth of any collateral in terms of market value
8. Omission of any clause requiring obligations on the bank (originator) to maintain (or enhance) composition of the securitised exposure for credit quality
9. Any calls or put options embedded in the contract

The sukuk were scrutinized with respect to the above mentioned clauses of securitisation framework in credit risk category of Basel II. The purpose was to see if risk transfer from originator to sukuk holders or any other third parties was taking place in sukuk securitisation, This risk transfer was based on the premise of transfer of ownership of underlying assets from originator to the sukuk holders. Only point no 1 above seeks answers to risk transformation from originator to the sukuk holders/third parties, while the other points seek protection for the third parties like the sukuk holders, from the originator, primarily in a debt-based system and product.

It was seen that significant risk of the sukuk contract still vests with the sukuk originator. thereby not allowing the concession to exclude the Sukuk assets from the calculation of risk weighted assets or to grant them a concessionary risk weight.

In the rest of the clauses, which entail safeguarding the sukuk holders, the sukuk provided those safeguards to the sukuk holders, but the originator did not remain free of the obligations even after the sale contract. These clauses are: No effective control of the

transferor or its creditors on securitised assets, and SPE/SPV as Transferee – Amortization plan, clean –up call.

5.1.4 Hypothesis IV results' summary

Hypothesis IV:

Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.

Hypothesis IV assesses whether the IFI originating the sukuk would qualify for getting risk weighting concessions (of CAR of Basel II). In terms of risk weighted assessment, the test results from Hypothesis III show that the sukuk securitisation fails to separate risk from the originator and hence does not benefit the originator i.e. IFI as far as risk reduction or risk – alienation is concerned. As a result, the sukuk originating IFI cannot qualify for the incentive of lower capital requirements based on Basel II's assessment through the securitisation framework. It does require allocation of capital provisions and risk weight categorization. As a result if it is asked whether or not the sukuk structures under study conformed to any structure in conventional finance? The answer would be, Yes, they conformed to conventional securitisation, except for the underlying asset-based structure, but whose effect is nullified through guarantees and repurchase agreement.

The answer to whether or not risk is transferred from IFI to sukuk holders, is No and Hypothesis III is tested to be false .i.e. Sukuk do not transfer risk from the originator to sukuk holders and hence the originating IFIs do not qualify for risk weighting concessions (of CAR of Basel II) . Hypothesis IV is tested to be false too.

5.2 Overall Conclusion of the Thesis:

While testing Hypothesis I, one of the sukuk samples selected for Ijara'h Sukuk partially conformed to Sharia principles for Ijara'h Sukuk under the AAOIFI Sharia'h Standards (1424-5H/2003-4) in being asset-based using the contract of Ijara'h but had other clauses which distorted the contract of Ijara'h. The other sample comprised a Musharakah Sukuk. It failed to comply with the basic modalities of Musharakah sukuk contracts. The contract of Musharakah between the originator and the SPV as agent of the sukuk holders existed, but the sukuk holders were given pre-agreed rates of return, without bearing any losses from the transactions. Both returns and loss modalities for sukuk holders were contrary to Musharakah principles. Hypothesis II tested the AAOIFI based sukuk attributes with conventional securitization. It proved that sukuk are securitization instruments while following the Sharia'h principles and not indulging in *riba* based practices of securitization, which were identified. Hypothesis III tested a sukuk sample for the possibilities of risk transfer due to securitization. Sukuk securitisation failed the test and showed that the risk is not transferred in the process. Transfer of ownership of underlying assets takes place in true sales, in which risk is definitely transferred from seller to buyer. Similarly, in Ijara'h contracts, risk of any loss or delay in Ijara'h rentals lies with the lessors. This means that true sale and true lease contracts didn't take place in the sample Ijara'h Sukuk securitisation. These results of Hypothesis III also strengthen the results from Hypothesis I which concluded that the representative samples of sukuk did not comply fully with the AAOIFI Sharia'h guidelines. Hypothesis IV further capped Hypothesis III, by giving the verdict whether or not, risk weighting concessions (of CAR) of Basel II would apply to sukuk originating IFIs. Since

significant risk is not getting transferred from the originator to the sukuk holders, the benefits of securitization cannot be reaped in the form of reduced capital requirements for the IFIs.

These hypotheses and their results are summarized in the following table:

Table 5.1 Hypotheses Summary

Hypothesis	Result
<p>Hypothesis I:</p> <p>Sukuk conform to the principles of Sharia'h</p>	<p>a) Ijarah Sukuk = partly Yes</p> <p>b) Musharakah Sukuk = No</p>
<p>Hypothesis II:</p> <p>“Sukuk are based on different securitization than that adopted in conventional instruments”</p> <p>a) AAOIFI's</p> <p>b) Sukuk in practice</p>	<p>a) Yes</p> <p>b) Some, no</p>
<p>Hypothesis III</p> <p>In Sukuk, risk is transferred from originators to sukuk holders, which is Sharia'h compatible</p>	No
<p>Hypothesis IV:</p> <p>Risk weighting concessions (of CAR of Basel II) apply to sukuk-originating IFIs.</p>	No

5.4 Observations and Recommendations

5.4.1 Producing a *Ribawi* Transaction

One observation regarding the sale and lease back transaction arrangement is that if the buyer (sukuk holders in this case) is leasing the asset to the same entity, and then selling the assets back to the same entity from whom it was bought in the first place, and yet at a pre-determined price, this can be interpreted as two or three contracts in one. These three contracts and their pricing are all part of the sukuk legal document, i.e. the prospectus. Hence a circular flow of transactions is created, which is very much akin to *riba* –based transaction, or can be termed as a back door to *riba*. On the other hand, the AAOIFI Shari’a Standards (1424H/2003-4) have not prescribed any standard sukuk contract structure or prospectus to follow. In addition, AAOIFI has not commented on this particular aspect of the transactions and is so far silent on the matter. In its statement or clarification regarding the sukuk¹²⁴, its point No. Five has stated the following:

“Fifth: It is permissible for a lessee in a Sukuk al-Ijara’h to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided he {lessee} is not also a partner, Mudarib, or investment agent.”

However, if the originator is not directly dealing with the sukuk holders and the SPV is acting as a go-between the sukuk holders and the originator, it is an investment agent of the sukuk holders, yet 100% owned by the originator who is the initial seller, the lessee and the final purchaser. In addition, even if there is an arrangement under which the originator

¹²⁴ http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf

unilaterally undertakes to purchase the assets, the substance of the contract should be looked at. These arrangements show that the contracts are nullifying their individual effects and producing a *ribawi* transaction.

5.4.2 Further implications of the Hypothesis III test results

Basel II analyzes the conventional products in terms of risk, as the debt –based products have separated risk from returns and derivatives have further distributed risks anomalously. However, Islamic finance does not propose risk and reward separation from the underlying asset and value addition process. Islamic Finance requires output along with the responsibility of the output to be together. Therefore Islamic Finance is against trade of debt at a value other than par. It is also against separation of risk from return. However, it does not propose that one partner to a contract can guarantee the returns to another partner in business. This too is impermissible. Hence based on our analysis of sukuk, putting it to test through Hypothesis I and II, the results show that except for the underlying assets, the sukuk are very much like conventional securitisation bonds. The only added features that they have and the conventional bonds lack are the guarantees and repurchase undertakings. However, these very features are contrary to the AAOIFI Sharia'h standards as providing guaranteed risk-free returns to one party to the detriment of another, has never been the purpose of the Sharia'h (AAOIFI, Sharia'h Standards, 1424 H/2004-5).

5.4.3 Recommendation for return and risk pattern of sukuk

From Sharia'h perspective, as per Sharia'h Scholars' clarification, there is no objection to using a money market rate as a mere benchmark for pricing an Islamic financial product. However, it would be better if an asset based sukuk, being based upon the real factors of production and the usufruct rights, be priced in terms of its underlying risk and return

structure, which would set the pricing of investments (capital) in the factors market instead of using the money market barometers of effective interest rates of securities and for banks. This would result in linking the return to investors in an economy with the actual output of the economy. It would also help alienate the issuers' cost of investments from any adverse changes in international lending rates (like LIBOR). (Jabeen Zohra & Khan, M R., 2007, 2008)

Offering prices that are based on the performance and output of the underlying activities and their costing means linking prices (hence return on sukuk) to the firms' profitability levels and efficiency. As a result, the relatively more efficient and profitable firms shall be able to offer better rates of returns than others. These benefits from such firms in the shape of better returns shall be shared with the contributors of capital (and better products and services, available to the people to purchase). Hence on the one hand it will cause capital rationing according to profitability, efficiency and demand for products and services, and on the other hand, the rewards (and risks) would be shared with the contributors of capital resources, equitably. In addition, if certain sector's firms offer even a lower return than others, they may be picked for investment, based on their stability of returns (Zohra & Khan Memoona, 2007). Hence the returns on sukuk securities should be linked to the returns from the underlying assets or the returns from the parent company's diversified portfolio, based on the expected internal rate of return on that capital employed by the firm in a sector and should be comparable to returns to equity holders of the firms. The status of sukuk shall be equal to a limited period equity sukuk, priced in the manner representing the real prices of the factors and commodities markets instead of the money market. This kind of linked pricing shall compliment the Islamic finance principles of dealing with real assets in financial transactions

of exchange and shall contribute towards the goal of equitable distribution of wealth. Otherwise, it will be an unjust allocation and asset-based products would remain only in form and ineffective in spirit, not in tune with the true purpose of the Sharia'h. When the benefits drawn and risks shared are against the spirit of the underlying transaction, it is an unjust allocation of resources and this means that the purpose of the asset-based transaction is defeated. There was no clear verdict of the Sharia'h scholars on this issue (when the paper was presented at the conference). However, now there is a view expressed by one of the very eminent Sharia'h scholars, Justice (Retd.) Taqi Usmani of the AAOIFI committee on the present day sukuk. He has mentioned some of the flaws in the sukuk while giving the benefits of the sukuk, if applied according to the Sharia'h requirements. According to him the sukuk are primarily meant for the purpose of enabling the sukuk investors to share in the profits of large enterprises or in their revenues. To quote him further, "If Sukuk are issued on this basis they will play a major role in the development of the Islamic banking business and thereby contribute significantly to the achievement of the noble objectives sought by the Sharia'h."

5.4.4 Positioning of the sukuk

A major issue seems to be the positioning of the sukuk by the market players (especially the originators and their advisors) as a bond-like instrument aiming to attract international investors in fixed income securities. Based on the analyses, and what the Sharia'h Standards have established, it is inferred that the sukuk need to be positioned as a type of shareholding like the Global Depository receipts, for raising more equity and sharing in the returns and risks according to the underlying type of sukuk. For instance, a Musharakah sukuk structure can be very much successful if it is positioned as a type of Global Depository Receipt

(GDR), based on the underlying concept of Musharakah sukuk, with nothing contrary to the principles of Sharia'h, instead of its current positioning to attract fixed income securities' investors. Similarly, other types of sukuk can also have the facility of converting to short-term or medium term equity or common equity. This can be complemented by flexible rates of return and risk sharing in tandem with the nature of underlying business activity

5.4.5 Participatory Sukuk and its advantages with respect to capital adequacy requirements for IFIs

Ideally, investors in sukuk should participate in the returns on Sukuk assets i.e. the rate of return on sukuk should be linked to the profit and loss from the underlying Sukuk assets based on certain agreement of sharing of risk and return. That would mean that (some of) the risk of the investments in the assets is (borne by and hence) transferred to the Sukuk investors. As a result, the capital (adequacy) requirement for the originating institution would be proportionately lesser. Along with this lesser requirement, the importance of supervisory role (Pillar II of Basel II) of regulators would increase, to ensure proper financial management and systems management by the originating institutions, to devise rules that would prevent insider dealings, and to ensure fair play among all stakeholders. The operational risk part of the CAR of IFSB is in line with the requirements for such a Sukuk, but they have to be much more detailed on a case-by-case basis. The role of the supervisors and the IIFS's management would be of utmost importance in its fair and efficient operation.

5.4.6 Different types – different regulatory implications:

Different types of sukuk arrangements can have different regulatory implications for IFIs. For instance, consider a sukuk floated by an IFI (as originator) such that the underlying sukuk project belongs to one of the IFI's subsidiaries or its sister companies, with whom the IFI has a Musharakah arrangement while the sukuk holders are offered a fixed rate of return on their principal investment. Apart from the right or wrong about such sukuk modalities, this is a case of concentration of wealth as the sukuk holders do not get a proportionate share in the wealth generation of the project, neither do they share the risk of loss in the project.

One of the parties to the contract is taking an undue advantage. This would lead to imbalance in the society as well as injustice from the point of sharing of business profits and losses among the group of companies. When the underlying sukuk project is a lucrative business venture it would mean giving a much lower percentage of the actual profit (or expected profit) of the underlying business, to the sukuk holders. Still another point of unfair business pertains to giving low rates of profit on ordinary bank deposits while using funds from the same pool and giving a higher return to its subsidiary or sister concern, which is a partner in the sukuk undertaking. Even from regulatory perspective, this is clearly causing agency issues in the banking industry. IFIs should compete for other and better sources of funds in the shape of floating securities but they should innovate in producing better financial products that benefit the banks as well as its stakeholders, including its investment account holders and the investors in the particular instruments (the sukuk investors). Apart from the general sukuk product modalities that are discussed separately, it means that the Islamic banking industry's sukuk must also be equitable by not make one stakeholder reap more benefit than others, or at the cost of other stakeholders. Given below the same argument is presented practically, in the form of a better sukuk alternative, that can be utilized by the IFIs. This is with the precondition that the sukuk structure too, is according to the Sharia'h guidelines, as discussed separately. This new IFI sukuk shall be based on the securitisation of the real assets' portfolios of the IFIs.

5.4.7 The proposed standard IFI Sukuk securitisation Structure

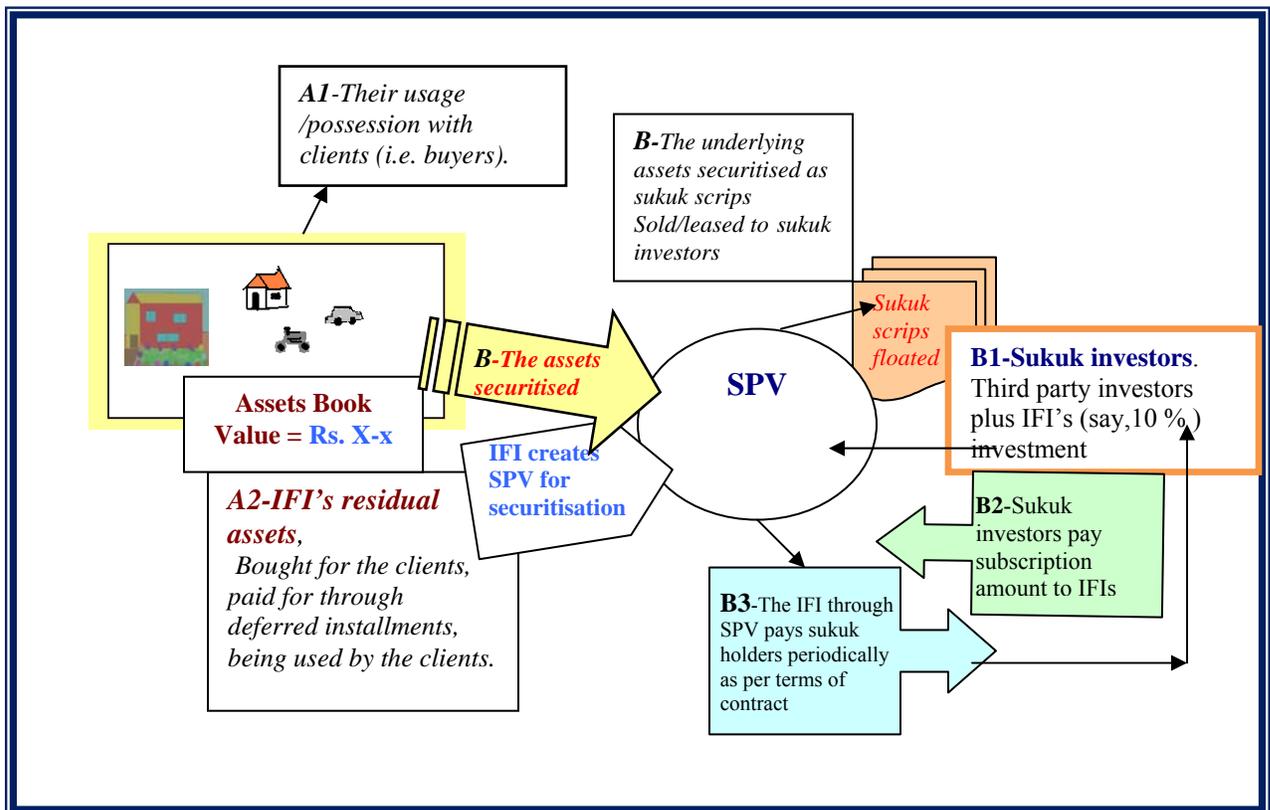
Based on the analysis done so far it is proposed that the sukuk securitisation structure may be availed to the benefit of the IFIs and in accordance to the Sharia'h principles, setting aside the clauses that defeat the purpose of risk transformation and equitable rewards sharing

among stakeholders in the sukuk formation. In the proposed standard IFI sukuk structure, the asset ownership lying with the IFI in the form of medium to long term contracts of diminishing Musharakah, Ijara'h and Mudaraba can be securitised to sukuk holders through issuance of sukuk investment scrips with which liquid, current assets can be generated for the IFI, while the underlying real, tangible assets are passed over into the collective ownership of sukuk holders. If the securitisation through sukuk also shares the returns from the underlying IFI transactions (except deferred payments as they qualify as debts, and should not be sold at more than or less than their par value) with the third party investors (sukuk holders) on a pro rata basis, or another arrangement, both the business risk and rewards will be shared between the sukuk investors and the IFI. The IFI can invest a certain portion (say 10 %) of its own equity in the sukuk too as a comfort factor to the sukuk investors as well as for its own diversification of streams of earnings. As a result the overall core equity of the IFI would increase. This manner of securitisation is being termed as the “standard sukuk” product, which is based on disseminating of the IFIs business risk, along with the sharing of profits from the business with the sukuk holders.

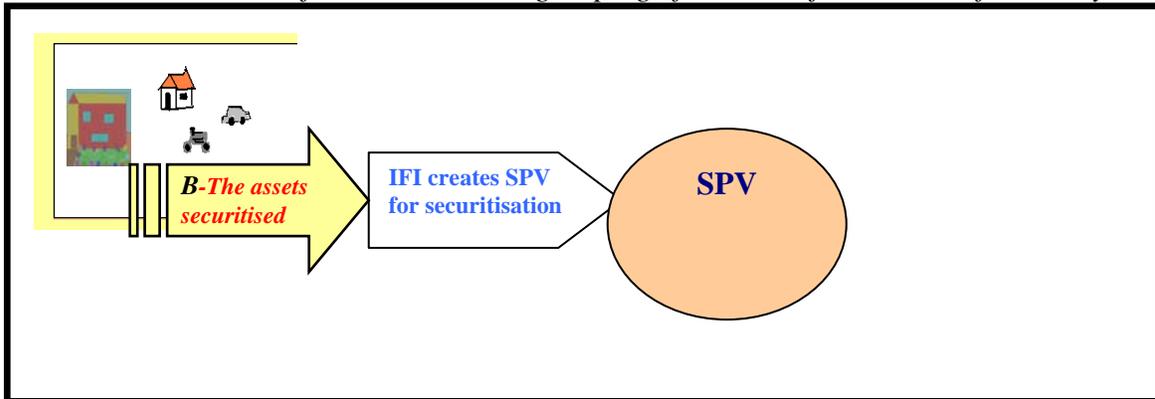
The usage of the product (standard sukuk) shall positively affect the capital adequacy position of the Islamic Financial Institutions (IFIs) in two ways. The core and supplementary capital of the IFIs shall rise above the minimum capital requirement and secondly, the level of minimum regulatory capital would get lesser due to sharing (or spreading) of the banking and business risk and rewards between the sukuk investors and the sukuk originating IFIs. There shall be no direct or indirect guaranteeing of any returns to any of the stake holders, while the bank as manager (Mudarib) shall ensure due diligence and managerial acumen and shall be liable for negligence in this regard.

The graphic presentation of the proposed standard sukuk according to Sharia'h principles is given below.

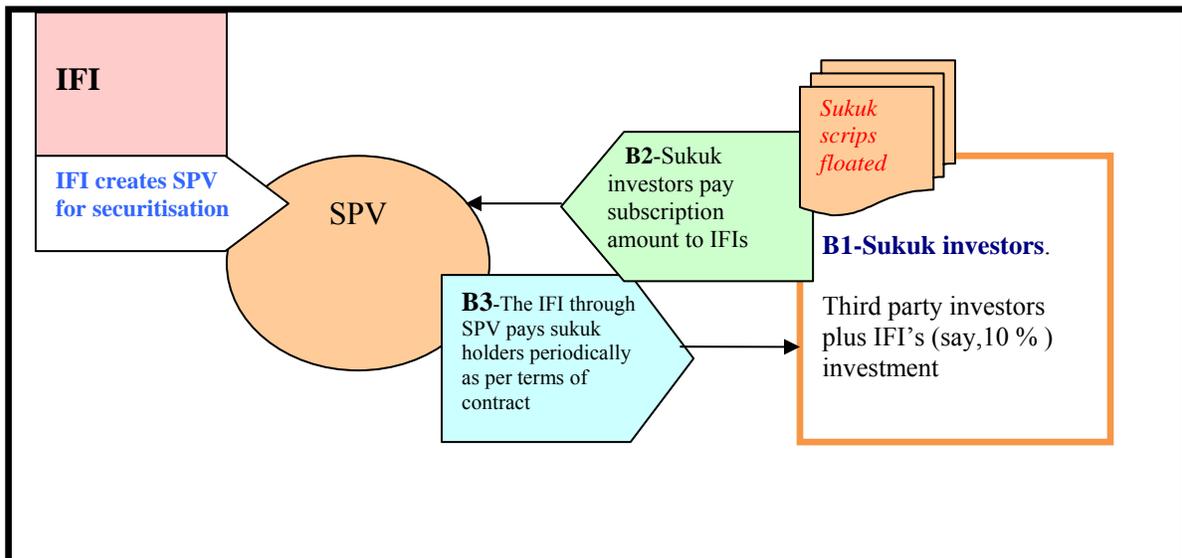
Figure 5.1
The proposed standard IFI Sukuk securitisation Model (All -in one)



Given below in the two frames, is the sub grouping of the same frame above for clarity



A: The asset ownership/usage rights securitised



5.1 Sukuk to remain Sharia'h permissible

This section is based on reflexive thinking from all the literature consulted and conclusions drawn as a result of the research process. Safeguard of wealth ("maal") is a recognized objective of Sharia'h. In the same capacity, it is required of the Muslims to earn a *halaal* livelihood from work or trade as well as just promotion of wealth for the sustenance and betterment of the family as well as society , according to the Sharia'h guidelines¹²⁵. This is so because , Allah(SWT) wants the whole society to be good and for people to deal with each other in the just manner and take utmost care of their rights and duties. In the process the also benefit from each other and have benevolent feelings towards each other. Having said that, it is a doable yet arduous task to achieve this objective and overall *Falah*. Likewise its immense rewards are from Allah(SWT).

Sayings of the Prophet Mohammad (SAW):

“The truthful merchant will be on the day of resurrection together with the Prophets, the faithful ones, the martyrs andd the pious people”

Ibn Majah, Sunnan, No. 2205, vol. 2, p. 743.

Sukuk being instruments of Islamic business for funds' generation and wealth utilization, must represent the objectives of Sharia'h. The objectives of Sharia'h with respect to Sukuk design should be as follows: There should be well-defined contracts with no room for disputes and unfairness, in order to promote wealth generation and utilization in an amicable environment, with no exploitation of one another. Similarly, there should be no *gharar* or uncertainty and ambiguity in the terms of the contract. *Gharar* brings about enmity among the

¹²⁵ This does not in any way should mean that attaining wealth should become the sole objective of life. The five mentioned objectives of Sharia'h are all intertwined and equally important with a well balanced approach for attaining welfare (*Falah*) of all.

contracting parties and sows the seeds of hatred and destruction in the society. Sukuk transactions should promote growth of the economy and wealth circulation according to the Sharia'h objectives.

5.5 Summary

The investigation commenced with examination of sukuk structures for their compliance with the Sharia Standards set forth by the AAOIFI (2003-4) and their resemblance or difference from conventional securitisations. It was expected that if sukuk are equity-based products and share risk and return according to the principles of Sharia, they can be an important product for Islamic Financial Institutions, as their risk based capital requirements would reduce, since Basel II has a system of rewarding the products that transform (or transfer) risk from the financial institutions (originators in this case) to third parties (sukuk holders in this case), by reducing their risk-weighted capital requirement.

Upon review of the sukuk structures, it was noted that they bear close resemblance to the structured finance products, albeit the presence of underlying assets or projects in the sukuk. While analyzing sukuk according to the requirements of AAOIFI Sharia'h Standards for them, the inquiry concluded that the sample sukuk are partly Sharia compliant according to Sharia'h Standards but not Sharia'h complaint on the basis of risk and reward sharing. The rigmarole of forming companies and SPV to fulfill legal and regulatory requirements, as well as providing guaranteed returns and assured principal along with repurchase of assets at pre-agreed prices neither shared risk and reward according to Sharia standards, nor did it transfer risk from the originator (or originating bank) to the sukuk holders or subsequent third parties whether an SPV or another issuer.¹²⁶ The transactions may remain off-balance sheet during

¹²⁶ When the same assets are securitised and sold to an SPV which is registered as a company, these regulations inclusive of capital adequacy requirements apply to it too¹²⁶. Otherwise it is feared, that the possibility exists of creating “shadow companies” as SPV's that escape the banking regulations.

the duration of the sukuk and the balance sheet might seem to be “light and efficient”. However, from Sharia as well as conventional regulations’ perspective, these transactions remain the liability of financial institution. Hence even if the sukuk are off-balance sheet, the SPV accounts should be consolidated with the parent organization (issuer of the sukuk) which wholly owns the sukuk company. It is suggested that if in any case the sukuk company has to report separately as a company, as part of a bigger conglomerate of companies, including non-financial companies, the financial part of such conglomerates should still be under the jurisdiction of financial regulatory bodies and adequate capital must be set aside for the financial business, and the required provisions made, according to the financial regulations.

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Reference to Al Quran

Al-Qura’n (2:22; 2; 29, 35, 36, 58; 5:120)

Excerpts

The Basis Of *Riba* Prohibition According To The Quran And Sunnah

A- From Al- Qura'n:

Chapter 2, Surah Al- Baqarah (Ayah [275] to 279 in continuation):

[275] Those who devour *Riba* (usury) will not stand except as stands one whom the (Shaitan) Evil One by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are Companions of the Fire; they will abide therein (forever).

[276] Allah will deprive usury of all blessing, but will give increase for deeds of charity; for He loveth not creatures ungrateful and wicked. [277] Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve.

[278] O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers.

[279] If ye do it not, take notice of war from Allah and His Messenger: but if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly. [280] If the debtor is in a difficulty grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. [281] And fear the Day when ye shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt with unjustly.

Source: <http://quran.al-islam.com/Targama/DispTargam.asp?nType=1&nSeg=0&l=eng&nSora=2&nAya=279&t=eng>
Al –islam, www.al-islam.com
Kingdom of Saudi Arabia, Ministry of Islamic Affairs, Endowments, Da'wah and Guidance

B: Ahadith on Riba

Riba Al-Fadl

“*Riba* al-Fadl is described as an unlawful excess in the exchange of two counter-values where the excess is measurable through weight or measure. The concept is based on Ahadith according to which if gold, silver, wheat, barley, dates, and salt are exchanged against themselves, they should be spot and equal and specified. If these conditions are not found, this transaction will become *Riba* al-Fadl. (Usmani, I. 2002, p. 253) Dr. Khalid Zaheer <http://www.renaissance.com.pk/Septrefl2y4.html#6>

‘If you give gold, then receive back the same gold: the same weight and the same quality; and if you give silver, then receive back the same silver: the same weight and the same quality, because the one who gives more or expects more, then [he should know that] that is exactly *Riba*.’ (Muslim 1981, p. 211) In another narration he is reported to have said: ‘If you will sell gold for silver then there is a danger of interest in it. [Likewise, if you will sell] wheat for wheat, barley for barley and dates for dates, the result would be no different; [there is no way of avoiding the danger of *Riba* in a barter transaction] except that the exchange be spot’. (ibid., p. 208)

Riba Al-Fadl in Gold, Silver, Wheat etc:

i.a.⁹ Narrated ‘*Umar*: The Prophet said, ‘The selling of wheat for wheat is *Riba* except if it is handed from hand to hand and equal in amount. Similarly the selling of barley for barley is *Riba* except if it is from hand to hand and equal in amount, and dates for dates is *Riba* except if it is from hand to hand and equal in amount.’ (Bukhari 1985, h. 2026)

ii.a. Narrated *Ibn Shihab* that *Malik Ibn Aws* said: ‘I was in need of change for one-hundred *Dinars*. *Talhah Ibn ‘Ubaydullah* called me and we discussed the matter, and he agreed to change (my *Dinars*). He took the gold pieces in his hands and fidgeted with them, and then said: ‘Wait till my storekeeper comes from the forest.’ ‘*Umar* was listening to that and said: ‘By Allah! You should not separate from *Talhah* till you get the money from him, for Allah’s Apostle said: ‘The selling of gold for gold is *Riba* except if the exchange is from hand to hand and equal in amount, and similarly, the selling of wheat for wheat is *Riba* unless it is from hand to hand and equal in amount, and the selling of barley for barley is *Riba* unless it is from hand to hand and equal in amount, and dates for dates, is *Riba* unless it is from hand to hand and equal in amount’. (ibid. h. 2029)

iii.a. Narrated *Abu Hurayrah*: The Prophet said: ‘If you give gold, then receive back the same gold: the same weight and the same quality; and if you give silver then receive back the same silver: the same weight and the same quality, because the one who gives more or expects more, then that is exactly *Riba*.’ (Muslim 1981, p. 211)

iv.a. Narrated by *Talhah Ibn ‘Ubaydullah*: ‘*Umar Ibn Khattab* said that the Prophet said: ‘If you will sell gold for silver then there is a danger of interest in it. [Likewise, if you will sell] wheat for wheat, barley for barley and dates for dates, the result would be no different; except that the exchange be spot.’ (ibid., p. 208)”

Source:“ Why is *Riba* Al-Fadl prohibited?”,Dr. Khalid Zaheer, <http://www.renaissance.com.pk/Septrefl2y4.html#6>

“Riba Al-Nasi’ah: Usury of Credit

The term *nasi’ah* in Arabic means to postpone. Muslim jurists’ define *riba al-nasi’ah* in loan as bringing to the lender a fixed increment after an interval of time, or extension of time over the fixed period and increase of credit over the principal (*fadl al-hulul ala al-ajal wa fadlal-‘a yin ala al-dayn*)

In other words, *riba al-nasi’ah* relates to the repayment period which is instrumental in earning for the lender a fixed increment rather than delays in repayment. This form of *riba* was common in pre-Islamic *jahiliyyah* and early Islam. It was also called *riba al-jali* or clear *riba*, and *riba almubashir* or direct *riba*. This form of *riba* was widespread in all credit transactions where a loan was advanced to a person on the payment of monthly interest over and above the principal. If a debtor could not repay principal with the accumulated surplus—interest at the time it fell due, he was given on extension of time in which to pay the loan but at the same time, the sum due was double. Hence, *riba al nasi’ah* signified the additional amount, which was paid by the debtor to his creditor over and above his creditors’ principal. In this sense, it has been forbidden by the Qur’an (Surah al-Baqarah verses 276-278 this form of *riba* by way of credit with a fixed period was prohibited without distinguishing between consumption and product loans.

In the strict legal terminology of the Shari’ah, *riba* is therefore defined as surplus, profit or increase in loans and sale—that is in all economic sectors, in agriculture, trade, commerce and credit for which no equivalent return, compensation or counter value (*‘iwad*) is given to other parties (debtor, buyer or laborer) who receive a lesser value in these transactions because one man’s gain is another man’s loss. Hence, *riba al-nasi’ah* is unlawful because the greater benefit is reaped by the rich, who becomes richer whilst the poor and weak suffer a situation which creates different socio-economic classes in society.”

Source: “Islamic Bond @sukuk” Prof. Dr. Mohd. Ma’sum Billah
masum@applied-islamicfinance.com http://www.applied-islamicfinance.com/sp_bondsukuk_1.htm

Selected Ahadith:-

✓ **From Hazrat Jabir Ibn-e Abdullaah (RA)**

The Prophet, (peace be on him) cursed:

- ✗ The receiver and the payer of interest,
- ✗ The one who records it,
- ✗ The witnesses to the transaction

And said they are all alike (in the guilt)

(Muslim, Tirmizi and Musnad Ahmad)

✓ In the words of Prophet (SAW) “Every loan that draws a profit is *riba*”

✓ It has been reported by Hazrat Abu Hurairah that the Prophet said: “Refrain from seven things which are deadly”. The companions asked him, what are these? He said,

- ✗ “To associate partners with Allah
- ✗ To cast spells
- ✗ To kill someone without a reason valid in the eyes of Allah
- ✗ To devour interest
- ✗ To devour the property of an orphan
- ✗ To run away from the battle field
- ✗ To falsely implicate innocent and chaste women of vulgarity”

✓ ***Hazrat Abu Hurairah has reported the Prophet to have said:-***

“Four categories of people are such that Allah has made it binding upon himself to refuse them admission to paradise or to let them enjoy its bounties.

- ✗ “The first is the one who is a habitual drinker of alcoholic drinks,
- ✗ The second is the one who devours interest,
- ✗ The third is the one who devours the wealth of an orphan,
- ✗ And the fourth is the one who is disobedient to his parents.”

✓ **Hazrat Abdullah Ibn-e Masood has reported that the Prophet said:**

“The ills of interest are a little over seventy, and it is as bad as associating partners with Allah.”

Hazrat Hanzala Bin Abdullah reported that the prophet said “ Devouring a dirham of interest is worse than committing adultery thirty six times, provided one is aware that he is utilizing money earned by way of interest.”

✓ **Hazrat Ibn-e-Abbas** has reported that the prophet instructed not to sell any edible fruits before they were fully ripe.

✓ He (PBUH) also said that when interest and adultery come in vogue in any society, then it is like they have invited Allah's wrath upon themselves.

✓ **Hazrat Abdulah Ibn-e-Masood** narrated that the Prophet said " as the day of judgement comes closer, interest, adultery and consumption of liquors will become common"

Isbahani has narrated on the authority of Hazrat Abu Saeed Khudri that in the night of Mairaj, the prophet saw some people on the heaven of the world whose stomachs were inflated like they were the rooms of a building, and these people could not stand upright. They were lying, one upon another, on the path which Pharaoh and his men are made to walk every day, in the mornings and evenings, leading to hell. The people lying over one another are subject to stampede by Pharaoh and his men. They pray that the day of judgement may never come. This is because they know that on this day they will be sent into hell. The prophet said " I asked Gabriel who were these people? He said these are those who devoured interest from among your followers. They will not stand except like one whom Satan has maddened by his touch."

✓ **Hazrat Anas** has said that when you lend to someone and he then sends you food as a gift, do not accept it, or if he offers you a ride, do not accept his offer except if the two of you had such relationship prior to the lending of money.

Sources MeezanBank's Guide to Islamic Finance , Imran Ashraf Usmani
IIIE's Blueprint of Islamic Financial System, International Institute of Islamic
Economics, International Islamic University, Islamabad, 1999

Excerpts Basel I and II

(a) Excerpts Basel I:

Basel I's Treatment Of Collaterals And Guarantees

Collaterals and guarantees were considered to have important bearing on credit risk but due to the varying practices among different banks in various it was difficult at that time (1988) to adopt a uniform policy or basis for recognising collaterals in the weighting policy. Only the collaterals in cash form and securities issued by OECD central governments and specific multilateral development banks were recognised. According to Basel I, loans against such collaterals carry the weight given to the collaterals (i.e. zero or low weight), if fully covered ,and if partially covered , only the partial amount would bear this favourable rating. Similarly loans or other exposures guaranteed by third parties who are “OECD central governments, OECD public-sector entities, or OECD incorporated banks will attract the weight allocated to a direct claim on the guarantor (e.g. 20% in case of banks)”¹²⁷. Also 20% weight applies to short term loans and exposures, guaranteed by non-OECD incorporated banks, with residual maturity within one year.

Contingent liability assumed by banks due to guarantees , was given a credit conversion factor of 100%.

Loans secured by residential property , which is rented or is intended to be occupied by the borrower, was **assigned 50% weighting**, and local supervisory authorities were left with the task of ensuring compliance with local housing finance regulations.....

The importance of understanding and **attaching credit conversion factors and risk weightage to off-balance sheet engagements** including recent innovations has been highlighted in Basel I. It was declared that they “ **be converted to credit risk equivalents** ¹²⁸ **and then weighted according to the nature of the counterparty**”. They¹²⁹ are divided into **five broad categories** (within which member countries will have some limited discretion to allocate particular instruments according to their individual characteristics in national markets).”

The categories , in brief are of , financial guarantees and their equivalents,(100 % credit risk conversion factor (CRCF)) , transaction related contingencies(e.g. performance bonds, bid bonds,..) 50% CRCF , short term self liquidating trade related contingent liabilities (e.g.

¹²⁷ The International Convergence of Capital Measurement and Capital Standards report (Basel I) dated July 1988 by the Basel Committee on Banking Supervision (BCBS), para 40, page 11

¹²⁸ by multiplying the nominal principal amounts by a credit conversion factor,

¹²⁹ different instruments and techniques

documentary credit collateralized by underlying shipments) 20% CRCF, Commitments will original maturity exceeding one year and all NIFs and RUFs- 50% CRCF, shorter term commitments or those which can be unilaterally cancelled carry a low or nil weight . Deliberations were made on accounting for interest and exchange rate related items like swaps , options , futures with respect to the cost of replacing the cash flow if the counterparty defaults. Two alternatives were considered, Members can choose among the two alternatives.

Many further developments have taken place in this area of off-balance sheet exposures and further innovations like securitisation etc. since Basel I. Although it had its limitations, Basel I laid the foundation of capital adequacy requirements with a better risk weighting system.

(b) Excerpts Basel II-

General discussion

Standardized Approach and Internal rating Based approaches are explained in detail describing how they can be applied and the conditions or preconditions of their applicability. According to the **Simplified Standardised Approach**¹³⁰, the general rules for risk weights of Credit Risk are given as follows:-

The first and foremost rule (point 1) given is that exposures should be risk weighted net of specific provisions. Through Consensus Country Risk Classifications eight risk scores categories associated with minimum export insurance premiums have been devised by export credit agencies (ECA) participating in the “Arrangement on Officially Supported Export Credits”. Each risk score corresponds to a specific risk category. On the basis of these scores, the **claims on sovereigns and their banks** are risk weighted (point A2) The scoring is as under :

ECA scores	0-1	2	3	4 to 6	7
Risk weights	0%	20%	50%	100%	150%

Exposures of banks to their own sovereign of incorporation or central banks, denominated and funded in domestic currency can , at national discretion, be given a lower risk weight and their national supervisory authorities may also allow the same rating (risk weight) to domestic currency exposures to this sovereign (or central bank) funded in that currency. (Point A 3)

Claims on other official entities, namely the International Monetary Fund, the European Central Bank and the European Community , would carry a 0% risk weight . *In addition a 0% risk weight for certain credible , well-known Multilateral Banks*¹³¹ too. However, the standard risk weight for claims on other MDBs will be 100%.

¹³⁰ Annex 9, The Simplified Standardised Approach , The International Convergence of Capital Measurement and Capital Standards report (Basel II) dated June 2004 by the Basel Committee on Banking Supervision (BCBS), page 228.

¹³¹ namely :- the World Bank Group, comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC),the Asian Development Bank (ADB), the African Development Bank (AfDB),the European Bank for Reconstruction and Development (EBRD),the Inter-

In addition, claims on Public Sector Entities would have the same risk category as the claims on banks of that category. National discretion is allowed in applying different treatments to different types of PSEs. Similarly, claims on a domestic PSE can be treated as claims on the sovereign of incorporation (in whose jurisdiction the PSEs are established), and in such a case “other national supervisors may allow their banks to risk weight claims on such PSEs in the same manner.”⁶

“Claims on banks and Securities firms:

Banks will be assigned a risk weight based on the weighting of claims on the country in which they are incorporated (see paragraph 2). The treatment is summarised in the table below:”

ECA risk scores for sovereigns	<i>0-1</i>	<i>2</i>	<i>3</i>	<i>4 to 6</i>	<i>7</i>
Risk weights	<i>20%</i>	<i>50%</i>	<i>100%</i>	<i>100%</i>	<i>150%</i>

Claims on Banks of an original maturity of 3 months or less, can be assigned by the national supervisor, a risk weight that is one category less than the risk weight assigned to claims on the sovereign (in which the banks are incorporated)

“ Claims on securities firms may be treated as claims on banks provided such firms are subject to supervisory and regulatory arrangements comparable to those under this Framework (including, in particular, risk-based capital requirements).⁶ Otherwise such claims would follow the rules for claims on corporates. The standard risk weight for claims on corporates, including claims on insurance companies, will be 100%.

(c) Excerpts from Credit Risk- Securitisation Framework–Basel II

3. Operational requirements and treatment of clean-up calls

557. For securitisation transactions that include a clean-up call, no capital will be required due to the presence of a clean-up call if the following conditions are met:

- (i) the exercise of the clean-up call must not be mandatory, in form or in substance, but rather must be at the discretion of the originating bank;
- (ii) the clean-up call must not be structured to avoid allocating losses to credit

enhancements or positions held by investors or otherwise structured to provide credit enhancement; and

American Development Bank (IADB), the European Investment Bank (EIB), the European Investment Fund (EIF), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), the Islamic Development Bank (IDB), and the Council of Europe Development Bank (CEDB).

(iii) the clean-up call must only be exercisable when 10% or less of the original underlying portfolio, or securities issued remain, or, for synthetic securitisations, when 10% or less of the original reference portfolio value remains.

558. Securitisation transactions that include a clean-up call that does not meet all of the criteria stated in paragraph 557 results in a capital requirement for the originating bank. For a traditional securitisation, the underlying exposures must be treated as if they were not securitised. **Additionally, banks must not recognise in regulatory capital any gain-on-sale, as defined in paragraph 562**

559. If a clean-up call, when exercised, is found to serve as a credit enhancement, the exercise of the clean-up call must be considered a form of implicit support provided by the bank and must be treated in accordance with the supervisory guidance pertaining to securitisation transactions.

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D. Treatment of securitisation exposures

1. Calculation of capital requirements

560. Banks are required to hold regulatory capital against all of their securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement, as set forth in the following sections. Repurchased securitisation exposures must be treated as retained securitisation exposures.

(i) Deduction

561. When a bank is required to deduct a securitisation exposure from regulatory capital, the deduction must be taken 50% from Tier 1 and 50% from Tier 2 with the one exception noted in paragraph 562. Credit enhancing I/Os (net of the amount that must be deducted from Tier 1 as in paragraph 562) are deducted 50% from Tier 1 and 50% from Tier 2.

Deductions from capital may be calculated net of any specific provisions taken against the relevant securitisation exposures.

562. Banks must deduct from Tier 1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income (FMI) resulting in a gain-on-sale that is recognised in regulatory capital. Such an increase in capital is referred to as a “**gain-on-sale**” for the purposes of the securitisation framework.

563. For the purposes of the EL-provision calculation as set out in Section III.G, securitisation exposures do not contribute to the EL amount. Similarly, any specific provisions against securitisation exposures are not to be included in the measurement of eligible provisions.

Excess spread

“550. Excess spread is generally defined as gross finance charge collections and other income received by the trust or special purpose entity (SPE, specified in paragraph 552¹³²)

¹³² “**9. Special purpose entity (SPE)**

552. An SPE is a corporation, trust, or other entity organised for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. SPEs are commonly used as financing vehicles in which exposures are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust.”

minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses.”

(ii) Implicit support

564. **When a bank provides implicit support to a securitisation**, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Additionally, **banks would not be permitted to recognise in regulatory capital any gain-on-sale**, as defined in paragraph 562. Furthermore, the bank is required to disclose publicly that (a) it has provided non-contractual support and (b) the capital impact of doing so.

2. Operational requirements for use of external credit assessments

565. The following operational criteria concerning the use of external credit assessments apply in the standardised and IRB approaches of the securitisation framework:

(a) To be eligible for risk-weighting purposes, the external credit assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. For example, **if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with timely repayment of both principal and interest.**

(b) The external credit assessments must be from an eligible ECAI as recognised by the bank’s national supervisor in accordance with paragraphs 90 to 108 with the following exception. **In contrast with bullet three of paragraph 91, an eligible credit assessment must be publicly available.** In other words, a rating must be published in an accessible form and included in the ECAI’s transition matrix. Consequently, ratings that are made available only to the parties to a transaction do not satisfy this requirement.

(c) Eligible ECAs must have a demonstrated expertise in assessing securitisations, which may be evidenced by strong market acceptance.

(d) A bank must apply external credit assessments from eligible ECAs consistently across a given type of securitisation exposure. Furthermore, a bank cannot use the credit assessments issued by one ECAI for one or more tranches and those of another ECAI for other positions (whether retained or purchased) within the same securitisation structure that may or may not be rated by the first ECAI. Where two or more eligible ECAs can be used and these assess the credit risk of the same securitisation exposure differently, paragraphs 96 to 98 will apply.

(e) **Where CRM is provided directly to an SPE by an eligible guarantor defined in paragraph 195 and is reflected in the external credit assessment assigned to a securitisation exposure(s), the risk weight associated with that external credit assessment should be used.** In order to avoid any double counting, no additional capital recognition is permitted. If the CRM provider is not recognised as an eligible guarantor in paragraph 195, the covered securitisation exposures should be treated as unrated.

(f) In the situation where a credit risk mitigant is not obtained by the SPE but rather applied to a specific securitisation exposure within a given structure (e.g. ABS tranche), the bank must treat the exposure as if it is unrated and then use the CRM treatment outlined in Section II.D or in the foundation IRB approach of Section III, to recognise the hedge.

3. Standardised approach for securitisation exposures

(i) Scope

566. Banks that apply the standardised approach to credit risk for the type of underlying exposure(s) securitised must use the standardised approach under the securitisation framework.

(ii) Risk weights

567. The risk-weighted asset amount of a securitisation exposure is computed by multiplying the amount of the position by the appropriate risk weight determined in accordance with the following tables. For off-balance sheet exposures, banks must apply a CCF and then risk weight the resultant credit equivalent amount. If such an exposure is rated, a CCF of 100% must be applied. For positions with long-term ratings of B+ and below and short-term ratings other than A-1/P-1, A-2/P-2, A-3/P-3, deduction from capital as defined in paragraph 561 is required. Deduction is also required for unrated positions with the exception of the circumstances described in paragraphs 571 to 575.

Long-term rating category⁸⁸

External Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ and below or unrated
Risk Weight	20%	50%	100%	350%	Deduction

Short-term rating category

External Credit Assessment	A-1/P-1	A-2/P-2	A-3/P-3	All other ratings or unrated
Risk Weight	20%	50%	100%	Deduction

568. The capital treatment of positions retained by originators, liquidity facilities, credit risk mitigants, and securitisations of revolving exposures are identified separately. The treatment of clean-up calls is provided in paragraphs 557 to 559.

Investors may recognise ratings on below-investment grade exposures

569. Only third-party investors, as opposed to banks that serve as originators, may recognise external credit assessments that are equivalent to BB+ to BB- for risk weighting purposes of securitisation exposures.

CAPITAL ADEQUACY RATIO AND COMPONENTS OF BASEL II

A- Basel II's Capital Adequacy Ratio (CAR):

$$\text{CAR} = \frac{\text{Capital}}{\text{Weighted risk Assets}}$$

B-Components of Basel II

Three pillars of regulatory framework

The First Pillar

- Minimum Capital Requirements

The Second Pillar

- Supervisory Review Process

The Third Pillar

- Market Discipline
-

C-Components of the first Pillar of Basel II

Minimum Capital Requirements

- A Calculation of minimum capital requirements
- B Credit risk (three subsections)
 - 1. The Standardised Approach
 - 2. The Internal Ratings Based Approach
 - 3. Securitisation Framework
- C. Trading Book Issues (including market risk)
- D. Operational Risk

Observations on STS-IDB sukuk

Market risk and provisioning for expected loss:

Looking at the offering prospectus/ the sukuk documents, the sukuk is legally worded in a manner that depicts that the transferor (which means the originator/originating bank, in our instance) “has to” repurchase the assets which are returned back by the customers, prematurely.

For all practical purposes the underlying assets are in the possession of the bank (originator’s) customers, while the names and modes operandi of the underlying transactions vary. A default (or delay) on payment, gives rise to bad debt and any safeguards available have to be revoked. There can be collaterals, in some cases registered mortgages, and other options. Nevertheless, a delay or default requires buffer capital and provisioning before – hand.

Explanation of the underlying contracts:

The aim of all the primary underlying contracts (*Murabaha*, *istisna’a* and *ijara’a*) to the sukuk issue is the (use and) acquisition of assets by the customers. In the case of leases, the asset is sold (at residual value) or “gifted” (at zero book value) at the end of the lease period, after its value and profit is recovered through periodic payments. In the case of *istisna’a* contracts, the bank finances the manufacture of the asset upfront through advance payments by bank and later sells the asset to the /a customer through deferred payments. *Murabaha* contracts usually employ sale of asset through deferred payments. Technically speaking, through deferred sales and through *Ijara’h* contract, the assets are in the physical possession of the customers, who are using the assets and paying back the installment price or the rent of usage (in *ijara’ah*).

In the case of *Ijara’h* contract **if the lessee, due to any reason, wants to terminate the contract beforehand and return the asset**, the chances are that the bank /originator will not suffer any loss in the transaction, in selling the asset in the market as the book value of the asset is usually lesser than its market price. However, there is, no doubt, an element of market risk involved in selling the asset in the market. **If the returned asset is destroyed or damaged, while in the possession of the customer**, in the absence of insurance cover or *Takaful*, the damages are to be recovered from the customer for misuse of the asset unless the damage is caused by Force Majeur¹³³. Over here, to safeguard against such loss, islamic insurance (*Takaful*) is required , if the bank do not want to do the conventional insurance. In *Murabaha*, the asset is’nt returned once the sale takes place. In *istisna’a*, a customer, for whom the assets are manufactured, may go bankrupt and go out of business altogether, while the assets are still “in-process”. The bank may have to find alternate buyers at the market (or offer) price. **This type of market risk can arise.** Hence, we can have situations where

¹³³ A Motorway destroyed by a natural calamity like floods, landslides, or even earthquakes, is a business loss to the bank/s unless it is insured in this respect , which again would mean heavy cost of insurance , and hence the weighing of cost vs benefits. If a car leased by a bank through *ijarah* , is lost /stolen , this is the loss of the bank. The bank generally insures the car(even in the absence of *takaful* arrangements)

the market value of the product/asset returned (at hand) is less than its net book value and the bank can suffer a business loss.

The accounting perspective:

In the case of *Murabaha* and *istisna'a*- based sales, there's normally no return of assets. If at all, there is a situation, where the asset is mortgaged and the customer defaults, the asset would be confiscated through court procedures. The (recorded) sale contract and necessary accruals would be reversed. That would mean reversing the necessary accounting entries and settling the accounts with the customer. **A better alternative in accounting entries** (not necessarily , only for *Murabahas* **but when deferred payment involved**) would be to record the outstanding sales amount as receivables so that provisioning for receivables is done on the outstanding amounts according to their aging beyond their due date. If the customer just stops the outstanding payments, which are deferred, this means default on the due amount and is to be treated just like any credit exposure. Provisioning for such exposures , as part of normal business risk , must be made, depending upon the nature of the commodity, the mortgage and guarantees obtained, those commodities' market conditions , the client's credibility , and other factors. It is this expected loss which may happen, (and has to be estimated from time to time, that can be covered through pure provisioning, (and insurance/*takaful* in some cases of *Ijara'h*) as proposed in broad terms in Basel I, and practically followed according to the national regulators' instructions, (prudential regulations). Likewise, if we were to follow and im plement Basel II in this context, each (underlying) transaction of *Ijara'h*, *istisna'a* and *murabaha*, (and others) as the case may be, shall have a credit conversion factor and risk weighting right from the onset, to be incorporated in the capital adequacy framework of the bank. Based on points a and b described above, the creation of SPVs and the floating of *sukuk* will not exonerate the bank from excluding the "securitised assets" from risk weighting for capital adequacy.

Risk Categorization

The researcher differs in **risk categorization** in Basel II (and if the same followed in IFSBs regulations) . As mentioned earlier, risk categorization does not necessarily have to be based upon OECD and non OECD approach but should have a more indigenous segregation based on the nature of the industry, its growth and risk factors, the impact of collaterals and guarantees (also mentioned to some extent in Basel I) the diversification pattern in the *sukuk* assets as well as the originators/guarantors' portfolio, the expected cash flows from the clients, with exposure on clients and categorization of clients, indigenously, as Class A, B and others, for instance like that mentioned in the Internal Rating Based Approach. However, the Internal Rating Based approach is quite complicated for local banks to adopt and implement and the cost of its implementation may outweigh its benefits for them.

Annex V

Ijara structures, which involve a sale and leaseback arrangement, escaped the criticism because they use an asset, usually a building, to raise money.

The building is placed in a special-purpose vehicle by the owner for a set amount, say \$100m. The SPV will raise the \$100m from investors to finance a business project. The SPV will then lease back the building to the owner for a set monthly fee, which will be paid to the investors.

As these are lease payments, no interest has been used to fund the project - in line with sharia law. As a building does not usually lose its value, the investors are in effect guaranteed their principal payment at par on maturity, although no explicit guarantee is made.

In the case of a musharaka, where one partner, usually a bank, puts the money into the venture and another, usually a company, puts in assets, such as a plot of land to be developed, the principal payment on maturity is guaranteed at par even though the investment may fall below face value. Usmani objected to this point¹³⁴

¹³⁴Usmani, Taqi., “Sukuk and their contemporary application” AAOIFI, April 2008