

**Property Finance Based on Covered
Bonds and Sukuk:
Requirements in Respect of Legal
Certainty of Property Rights**

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Requirements of Sustainable Property Finance

There is an urgent need for affordable housing in Asia, MENA countries and Brazil, due to sheer pressure of population growth. The Credit Crisis has demonstrated the need for a reliable funding basis across cycles – not only in the emerging, but also in the “old” economies. Funding instruments should at least to a large extent

- be long-term to avoid temporary liquidity bottlenecks;
- match the maturity terms of the assets to be financed.

These requirements can be met particularly well by Covered Bonds and Sukuk.

Covered Bonds and Sukuk: Common Basic Principle

Payment claims of investors are covered by assets (in this case: real estate assets) and income streams generated by these assets. The related legal basis – in particular coverage requirements - can be

- Statutory, i.e. prescribed by law
 - examples: Covered Bonds, defined and regulated by several EU jurisdictions, e.g. German Pfandbriefe

- Contractual, i.e. based on individual documentation
 - examples: non-regulated Mortgage Backed Securities; recent Sukuk issues

Covered Bonds and Sukuk: Characteristics

- Covered Bonds: securities, where the obligors' payment obligations are covered by assets (in this case: real estate assets) and by income streams generated by these assets. Restricted definition with specific requirements for privileges under the EU Capital Requirements Directive („CRD“, Basel II). In „traditional“ banking normally structured as debt securities.
- Sukuk: instruments where the interest in assets and related revenues is securitised. They can mature at a set date. However, as a Shari'ah-compliant type of security, they do not guarantee repayment or a profit.

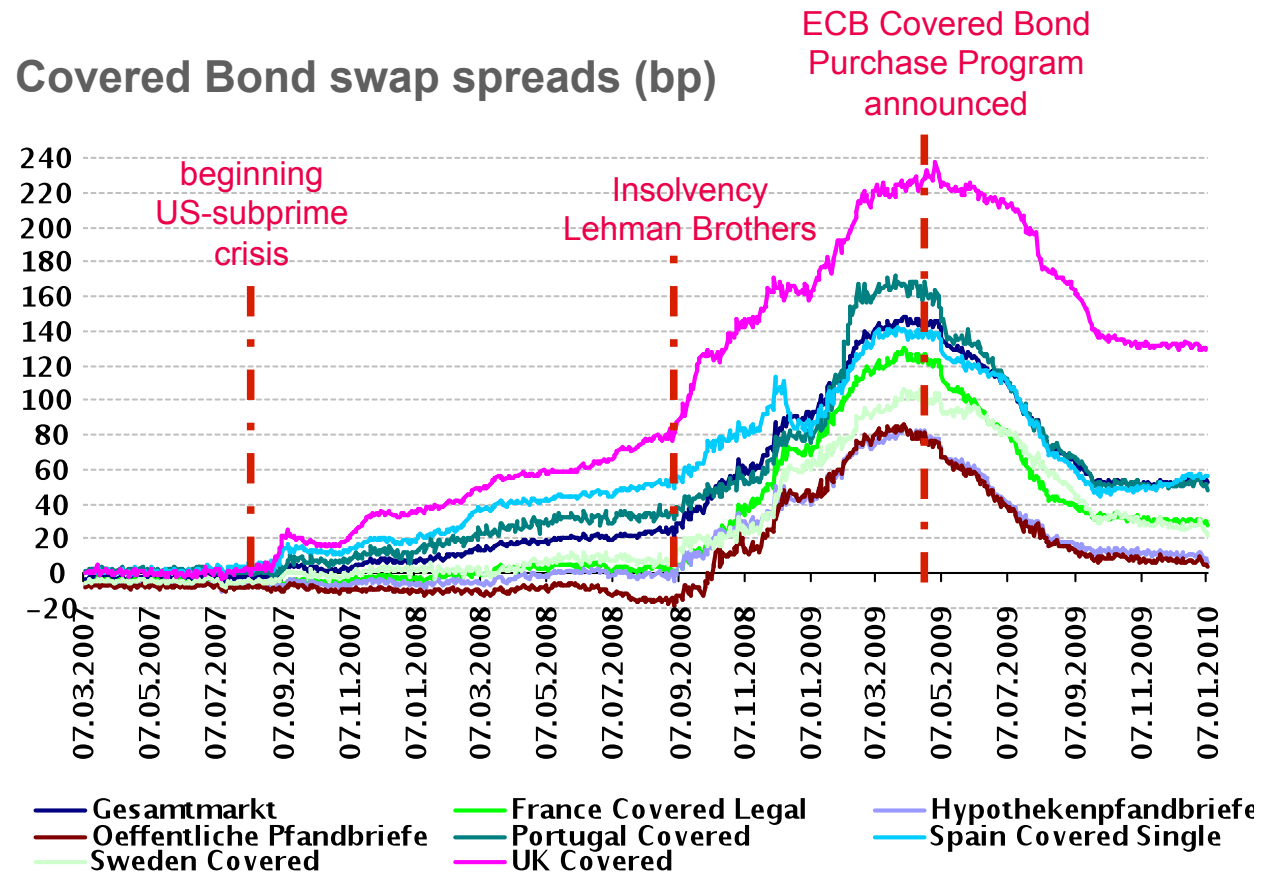
Further, the underlying assets and the issuer itself must be Shari'ah-compliant (bans of Riba, Gharar and Maisir)

Lessons of the Credit Crisis

Strictly regulated statutory covered bonds have weathered the crisis fairly well, compared to other capital market funding instruments.

- There was a reasonable degree of secondary market liquidity for classified covered bonds under European and other international regulation, whereas the MBS markets practically dried up.
- Although related spreads had widened significantly during the crisis, they have come down dramatically in the meantime.
 - Crisis Peaks between 380 bps (Irish CBs) and 140 bps (German „Pfandbriefe“);
 - „Pfandbriefe“ spreads have come down to levels around 10 bps
 - * 1bp = 1/100 percentage point. The spread over mid-swap is an indicator of the price of funds.
- The resilience of covered bonds depends on
 - the quality of cover assets;
 - the strictness of regulatory requirements;
 - the soundness of the governing jurisdiction, in particular the certainty of property rights.

... in secondary markets



Mortgage and Public Pfandbrief not affected by financial turmoil to the extent observed in other European Covered Bond markets

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Covered Bonds and Sukuk: Recommended Requirements - Certainty of Property Rights

The soundness of the governing jurisdiction, in particular the certainty of property rights, is a major factor in attracting investors. Therefore, the methodology of Rating Agencies caters for jurisdiction-based rating uplifts.

Basic legal requirements:

- Clearly defined and enforceable property rights covering ownership, transfer and collateral for claims;
- Property rights must be unambiguously allocated to owners and beneficiaries.
 - This can be achieved by official registers established with public faith.
- Property rights must be unambiguously allocated to the underlying physical real estate.
 - This can be achieved by land registers based on an official public cadastre.
- The judiciary system must ensure reliable and speedy enforcement and execution of property rights.

Covered Bonds and Sukuk: Recommended Requirements – Further Legal Basics

The soundness of the governing jurisdiction has to include:

- A clearly defined and enforceable legal basis for securities, transfer of claims and rights, and securitisation;
- clearly defined and enforceable corporate law in respect of issuing entities;
- a clearly defined and enforceable legal basis for insolvency and insolvency remoteness.

Covered Bonds and Sukuk: Recommended Specific Requirements for a Successful Introduction

Following the example of successfully established covered bonds frameworks, a few issues should be mandatory:

- Stringent requirements re. eligibility and quality of underlying assets: real estate and/or related revenues (e.g. rental income or Ijara) with certain risk restrictions
 - „LTV“ ceilings
 - over-collateralisation;
- Cover pool structure and insolvency remoteness: clear and, if necessary, separate insolvency procedures for cover assets. 3 alternative models are customary:
 - Preferential claim of bondholders on a segregated on-balance asset pool of the issuer (i.e. not part of its insolvency estate). If the issuer is insolvent, the cover pool assets are used exclusively to satisfy the claims of covered bondholders (German Pfandbriefe).
 - Insolvency-remote subsidiary - explicit legislation, as opposed to a merely contractual framework (French Obligations Foncières)
 - Transfer of the cover pool to a guaranteeing vehicle (UK model)

Covered Bonds and Sukuk: Recommended Specific Requirements for a Successful Introduction (Contd.)

- Regulation for the orderly continuation of the cover pool in case of the issuer's distress.
 - In particular, access to liquidity, e.g. by central bank liquidity lines.
- Ongoing governmental supervision of the issuing entity and the cover pool (including on-site assessments).
- Market making for benchmark issues, possibly by central banks involved.
 - Criteria of benchmark issues should be explicitly defined.
 - Central bank purchase programmes might support a kick-start.

Covered Bonds and Sukuk: Cross-border Transactions

Cross-border harmonisation of related private law issues is not realistic. Nevertheless, enforcement of foreign judgments and choice of law (conflicting law) rules must be clear and agreed upon.

3 Jurisdictions would be involved:

- The jurisdiction governing the formation of each of the entities involved, in particular the issuer;
- the jurisdiction in which the underlying assets (real estate) are located;
- the jurisdiction governing the transactional documentation.
- Harmonisation efforts outside the EU
 - AAOIFI standards for Sukuk
 - Agreements of mutual recognition of common standards, e.g. GCC / Malaysia

Sukuk-based Property Finance in MENA and Asia

Sukuk is a growing market – global outstanding volume may extend to USD 200bn in 2010, compared to USD 97bn at yearend 2007. These growth rates should qualify Sukuk for the following targets:

- Establishment of a global capital market funding instrument for Shari'ah-compliant finance of real estate including residential property
 - examples: ALIM/Malaysia (residential); individual commercial real estate transactions;
- establishment of a capital market instrument with sufficient critical mass to be used as collateral for transactions of Islamic banks with domestic and international central banks.

Problems: The Sukuk market is still fragmented and confronted with a lack of depth (secondary markets not developed).

- These problems could be tackled by implementing the introduced recommendations (if appropriate in the national environment).

Covered Bonds and Shari'ah-compliant Assets / EU

- Ijara (lease) and Murabaha (forward sale) - based real estate transactions can be structured in a format such as to be eligible under the national covered bonds regime of several EU countries, including Germany.
- Most EU jurisdictions require cover assets to be located in the EU or in one of very few eligible non-EU countries.
- Issuing entity needs a banking licence and residence of an EU country.

Shari'ah-compliant Finance under EU Jurisdictions

There is a source of capital available which can be tapped only via Islamic Finance. Governments world-wide are taking measures to accommodate Islamic Finance and Sukuk. Ca. 14m Muslims are EU residents (thereof Germany: 3.5m).

- UK: Officially supported Commission for the introduction of Islamic Finance. Advanced legislation re. taxation and banking regulation in place. Shari'ah as such not enforceable by courts, i.e. cannot be agreed as law of choice.
- France: Government Commission for the introduction of Islamic Finance. Legislation re. taxation has been finalised. Shari'ah can be agreed as law of choice.
- Germany: First issue of Sukuk by a government (Sachsen-Anhalt) in the EU. Shari'ah clauses can be integrated into contractual frameworks. Action should be taken particularly in respect of:
 - tax-neutral regime, in particular re. real estate transactions;
 - definition of bonds to accommodate Sukuk (e.g. ECB money market transactions, privileges for liquidity and capital requirements for banks and insurance companies).

Shari'ah-compliant Finance in Germany: Outlook

Banks applying the principles of Islamic Finance have performed fairly well during the crisis. They cannot escape the deterioration of the global economy and falling asset prices. However, they were not much affected by the first round core crisis, because they are much less exposed to the systemic drivers of the liquidity squeeze:

- Due to the closer link of Islamic finance instruments to the real economy, there is less leverage in the system.
- In general, Islamic banks have a strong commitment to asset-based transactions, which insulates them from specific internal risks of the financial system.
- Accommodating Islamic Finance in traditional banking systems could be a stabilising factor.
- It would be worthwhile to establish the necessary legal environment to accommodate Islamic Finance, in particular in the real estate segment. This is particularly true taking into account the high standards in the certainty of property rights in this country.

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Many thanks for your attention

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