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## GUEST AUTHOR

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### GUEST ANALYSIS: ESTABLISHMENT OF A LIQUID GLOBAL CROSS-BORDER SUKUK MARKET

By Dr. jur. Klaas Peter Follak, International Lawyer and Economist\*

*Westlaw Business Note: Islamic finance, and sukuk in particular, are at a crossroad amid last year's economic downturn and the unraveling of the Dubai crisis. Yet as the economy creeps back and there is an increased need for liquidity, sukuk are expected to again grow in 2010, particularly in the area of real estate, where sukuk ijara have long been a valued mechanism for financing transactions.*

#### 1. General

In economic terms, sukuk are very similar to conventional bonds: purchasers aim to earn a profit, and they mature at a set date. However, as a Shari'ah-compliant type of security, they do not guarantee a profit.<sup>1</sup> According to a Moody's report, the global outstanding volume may expand to USD 200bn in 2010, compared to USD 97bn at yearend 2007<sup>2</sup>, and annual issuance volumes of up to USD 34bn in the past. These growth rates should qualify sukuk for the following targets:

- establishment of a global wholesale funding instrument for Shari'ah-compliant finance of real estate, including residential property;
- 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.

The need for increasing the supply of liquid high-quality assets<sup>3</sup> has been underscored by the recent liquidity squeeze: "...the development of a domestic bond market would provide a mechanism to manage systemic and private sector liquidity more smoothly across cycles...UAE banks' liquidity risk management capacity is constrained by an insufficient diversification of the liquidity base...local banks had to rely on the growth of their deposit base, and had to borrow abroad with little insurance on the rollover prospects in case of tensions..."<sup>4</sup> Sufficient central bank liquidity in the traditional Western hemisphere for Islamic finance institutions is still a challenge.<sup>5</sup> The basic requirements would be:

- a critical mass sufficient for a benchmark curve over a full range of maturities up to 10 years;
- beneficial pricing to cater for advantageous funding of Islamic residential real estate finance.

Listing of sukuk on international stock exchanges does not cause any major problems, and sukuk are increasingly attracting not only Islamic, but also conventional fixed-income debt investors. However, the sukuk market is still fragmented and confronted with a lack of depth,<sup>6</sup> and a liquid secondary market is essentially non-existent.<sup>7</sup> With growing competitive demand for available liquidity in a still risk-averse environment, action is required.

#### 2. Breaking the Deadlock

The lessons learned from the recent credit crisis, though painful, might have paved the way. Even during the crisis, there was a reasonable degree of secondary market liquidity for strictly regulated instruments classified as covered bonds under European and other international regulation. "Indeed, covered bonds proved up to now to be relatively resilient to the market correction", compared to other wholesale funding instruments.<sup>8</sup> Although Islamic finance products were much less exposed to the systemic drivers of the liquidity squeeze, they cannot escape the downturn of the real economy, which has been demonstrated by a few recent problems with Gulf countries' sukuk. "The promotion of a thriving global market for Islamic products is therefore dependent on strong co-operation among regulators to maintain a high level of investor protection across borders."<sup>9</sup> Basically, this can be achieved by sukuk granting an interest in secure assets and / or related income streams. A robust and transparent statutory legal framework is required, since investors are still reluctant to buy ABS / MBS structures based on contractual agreements only. This is why related legislation is being considered in the U.S. as well<sup>10</sup>. Investors must be convinced that the quality of cover assets and bankruptcy segregation justifies meaningfully tighter spread levels than unsecured bank issuance. Simply achieving AAA ratings is not sufficient.

#### 3. Minimum Requirements

The experiences of the credit crisis have demonstrated that the strictness of the legal and regulatory framework has a great impact on the resilience of covered bonds, although the underlying economic

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strength of the issuer's country of residence plays a major role as well. The market size of EU covered bonds is estimated at € 2.4 tn. Since mid 2007, we saw a dramatic widening in spreads of regulated covered bonds versus mid-swaps; with peaks of approx. over 380 bps (11) for Irish, 270 bps for UK, over 200 bps for Spanish, and up to 140 bps for German („Pfandbriefe“) covered bonds. (12) In the meantime, they have deflated dramatically. The updated S & P rating methodology caters for jurisdiction-based rating uplifts according to the soundness of post-insolvency liquidity ( e.g. 5-7 notches for Danish, French, German and Spanish, 4-6 for UK, and 3-5 for Greek and US covered bonds (13).

The alternatives:

### 3.1 Established Framework

Issuing sukuk, directly applying the regulatory framework of a recognised jurisdiction under which good results have been achieved: this could open the door to privileged investments by EU banks (significantly lower capital requirements under Basel II) and institutional investors under the EU UCITS Directive (14). Basically, Ijara-based finance transactions can be structured in a format such as to be eligible as coverage under the national covered bonds regime of several EU countries. However, it might be a challenge to accommodate the Shari'ah requirements for sukuk. Most EU jurisdictions require real estate cover assets to be located in an EU or in one of the very few eligible non-EU countries. In addition, the issuing entity would need a banking licence ( and residence ) of an EU country ( at least as a specialised banking institution ).

### 3.2 Specific Sukuk Framework

In essence, stringent legislation and regulation by the country of residence of the issuer is a must. This is in particular true in respect of the state of development of bankruptcy law and other legal issues in many Islamic finance jurisdictions. For this reason, it could have been difficult to obtain clear legal opinions in certain cases in the past. (15) As a first step, such legislation could be confined to core problems of sukuk. Minimum harmonisation within a group of countries with significant volumes of Islamic finance would achieve added value, broadening the critical mass. The agreements with several Gulf countries, signed by Malaysia, on developing Islamic finance including mutual recognition of common standards might be a start. Following the example of successfully established covered bonds frameworks, a few issues should be mandatory:

- Eligibility and quality of underlying assets: real estate and/or related income (Ijara) with certain risk restrictions („LTV ceilings“ or „over-collateralisation“). How this requirement can be achieved applying Shari'ah-compliant structures, would have to be subject to further in-depth investigations. For example, risk and profit sharing with an interbank or government agency might be considered. Apart from that, claims against public-sector entities would be possible, to enable Public Private Partnership finance. (16) Certain EU jurisdictions (e.g. the German Pfandbrief Act) include ship and aeroplane finance, but this would not be advisable for the initial steps. However, residential property should be included to achieve a satisfactory market depth – over 70% of the Islamic finance market is based on consumer finance, due to demand by the Muslim Middle Class.(17) Simply relying on fragmented commercial property projects would not be enough.
- Cover pool structure and bankruptcy remoteness: At least under the jurisdiction of the issuer, clear and, if necessary, separate bankruptcy procedures for cover assets should be established. Again, how this requirement can be achieved by applying Shari'ah-compliant structures, would have to be subject to further in-depth investigations. Three models are customary under established covered bonds frameworks :
  1. Preferential claim of the bondholder on a segregated on-balance pool of assets of the issuer ( in particular, separate estate in the case of its insolvency, i.e. not part of the bankruptcy estate ): In the event of the issuer's bankruptcy, the assets in the cover pool are used exclusively to satisfy the claims of covered bondholders. Other creditors have no access to these assets until all covered obligations have been fully repaid (German Pfandbriefe model).
  2. Bankruptcy remote subsidiary:  
The cover assets are transferred to a bankruptcy remote subsidiary which uses these assets as coverage for the covered bonds ( French Obligations Foncières model ). Please note that this model is based on explicit legislation, as opposed to a merely contractual framework.
  3. Assignment of the cover pool to a guaranteeing vehicle: A subsidiary of the above-mentioned type will issue a guarantee for a bond from the originating bank (UK model). Due to the guarantee-based structure, it might be difficult to implement Shari'ah-compliant structures.
- Regulation for the orderly continuation of the cover pool (as opposed to acceleration ) in case of the issuer's distress. In particular, the pool will need to have access to liquidity, e.g. by central bank liquidity lines granted against collateral. (18)
- Ongoing supervision of the issuing entity and the cover pool (including on-site assessments).
- Market-making for benchmark issues, possibly by central banks involved. In particular, the criteria of benchmark issues should be explicitly defined. In the case of European covered bonds, a related ECB ( European Central Bank ) purchase programme has been of significant help in kick-starting the market after the crisis.(19)

### 3.3 Issues re. Multi-Jurisdiction Transactions

In case of cross-border transactions, three jurisdictions would be involved (20) :

- The jurisdiction governing the formation of each of the entities involved in the transaction, in particular the issuer;
- The jurisdiction in which the underlying assets are located;
- The jurisdiction whose law has been chosen as governing the transactional documentation.

Cross-border harmonisation in respect of the related private law issues does not seem to be realistic, and has not even been tackled in the EU. Nevertheless, enforcement of foreign judgments and choice of law (conflicting law) rules must be clear and agreed upon. Even on the basis of proper choice of law rules, there is a remaining risk in respect of cross-border insolvency, because insolvency law is national and not contractual. Solutions could be possible by establishing contractual security or access rights for the benefit of the bondholders as an add-on to related privileges under the issuer's jurisdiction.

## 4. Shari'ah issues

Any in-depth analysis of the Shari'ah issues involved in cross-border sukuk markets would by far exceed the range of coverage of these few comments.(21) Again, cross-border harmonisation does not seem to be realistic. Nevertheless, the basic requirements should be remembered:

- The underlying assets must be Shari'ah-compliant, as well as the issuer itself. This excludes prohibited transactions such as traditional finance, where Riba is charged; (22)
- The ban of Gharar – any excessive ambiguity, uncertainty or lack of specificity affecting the principal components of the contractual framework; (23)
- The ban of Maisir ( speculation with the element of gambling ) ;(24)
- The ban of Riba ( the fixing in advance of a positive return on capital as a reward for waiting). (25)

Under these aspects, establishing a cover pool with Shari'ah-compliant residential property finance assets might be a challenge, because scholars in a number of Islamic jurisdictions state that murabaha debt cannot be securitised. (26) However, the prevailing view of Malaysian scholars differs, as long as the underlying receivable is connected to a true trade transaction. (27) Further, in an alternate form of Ijara contracts, known as Ijara-wa-igtina („rent-to-own“), the lessee will eventually own the leased property. A portion of the monthly payment installment is considered rent for use of the property, while the other portion is paid toward ownership until the customer owns 100% of the property, at which title passes to the lessor. (28) Hence, Shari'ah-compliant securitisation of large residential property finance portfolios should be possible.

Further problems of international transparency are caused by the fact that the AAOIFI ( Accounting and Auditing Organisation of Islamic Financial Institutions ) accounting principles are not founded on an interest-based set of principles ( i.e. they cannot be compared with EU or U.S. GAAP ). (29) This could be compensated by clear legal guidelines for the quality of eligible assets and income streams.

## 5. Collateral Requirements of Western Hemisphere Central Banks for the Access to Liquidity and Regulatory Liquidity Requirements

As mentioned under item 1, access of Islamic finance institutions to the Euro and USD markets is essential. In addition, Islamic finance institutions will need assets which are eligible for liquidity reserves under the proposed Basel Committee liquidity requirements. Even given full compliance with the above requirements and criteria, many international central banks will have to take steps to accommodate sukuk for access to liquidity. The ECB, e.g., requires „debt instruments“ to have a fixed, unconditional principal amount even in the case of covered bank bonds. Otherwise, very restrictive ABS requirements would apply. (30)

Nevertheless, where there is a will, there is a way. The UK Financial Services and Markets Act 2000, as amended by the order 2010, has already applied the general bond regulations to „alternative finance investment bonds“ to include sukuk. (31)

## 6. Outlook

Following the related purchase programme of the ECB, international covered bond markets are being kick-started. The issuance of covered bonds will be essential in respect of exit strategies for central banks after the crisis. The ECB has already advised the replacement of government guaranteed securities by covered bonds as a target. It might be advisable to start the development of the necessary sukuk framework as soon as possible to benefit from the new wave. The aftermath of the credit crisis might well be an era of collateralised funding on the basis of good quality assets, of which sukuk deserve to have their share.

### The author:

\*Dr. jur. Klaus Peter Follak is an international lawyer, financial services expert, and advisor to several international governments.

E-mail address: [info@apfollak.de](mailto:info@apfollak.de). For more details see the website [www.apfollak.de](http://www.apfollak.de)

- 1) Islamic Finance in Terms: Sukuk Ijara, A Securitization by any other Name, Westlaw Business Currents 9th July, 2009.
- 2) UK HM Treasury / FSA, Consultation on the legislative framework for the regulation of alternative finance investment bonds ( sukuk ), Dec. 2008, p.9.
- 3) A. Chailloux / D. Hakura, Systemic Liquidity Management in the U.A.E.: Issues and Options, IMF Working Paper WP/09/261, Dec. 2009, p. 4.
- 4) Ibid., pp. 4, 13, and 14.
- 5) Islamic Finance in Saudi Arabia, speech by M. Al-Jasser, Governor, Saudi Arabian Monetary Agency, at the BaFin Conference on Islamic Finance, Frankfurt 29th October 2009.
- 6) Ibid.
- 7) M.J.T. McMillen, Securities Laws, Enforceability and Sukuk, Islamic Financial Services Board ( Ed. ), Islamic Finance: Surveys on Global Legal Issues and Challenges, Kuala Lumpur 2008 p. 93.
- 8) J.C.Trichet, Chairman, European Central Bank, address on the „originate to distribute“ finance model, October 2008
- 9) Z. Anwar, Malaysian SC Chairman, Re-examining Approach and Philosophies on Regulation of the Markets, Quarterly Bulletin of Malaysian Islamic Capital Market, Vol. 4 No.2, June 2009.
- 10) On December 15th, The House of Representatives Financial Services Committee held a hearing entitled: „Covered Bond: Prospects for a U.S. Market Going Forward.“ Until then, there was only an FDIC statement on the treatment of covered bonds that fulfil certain minimum criteria, followed by a Treasury statement on „best practices“ ( both 2008 ). So far, there were no issues from US banks under that framework.
- 11) 1bp =1/100 percentage point.
- 12) J. Sarafana, Der Markt für Covered Bonds als Thermometer für die Finanzkrise, Immobilien und Finanzierung issue 22/2009, pp.24. It has to be noted that some of these spreads are indicative only and not always based on actual transactions.
- 13) Based on the current U.S. situation lacking explicit legislation.
- 14) Dir. 85/611 EEC as amended by Dir. 2005/ I / EC, Art. 22 IV.
- 15) McMillen ( supra FN 7 ), pp.138.
- 16) The Sukuk issued by the German regional government of Sachsen Anhalt, listed on the Luxembourg stock exchange, is a good example.
- 17) Ibrahim ( FN 23 ), p. 667.
- 18) This issue is also being discussed in the US initiative mentioned supra FN 10.
- 19) Announced in May 2009, to be phased out in June 2010.
- 20) For a comparative summary of national securities laws, see McMillen supra FN 7, pp.110.
- 21) See the AAOIFI ( Accounting and Auditing Organisation of Islamic Financial Institutions ) Standard for Investment Sukuk ( 2003 ) including the Clarification of March 2008, and, in particular in respect of asset securitisation, Quarterly Bulletin of Malaysian Islamic Capital Market ( supra FN 9 ).
- 22) A.H. Abdel-Khaleq / C.F. Richardson, New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings, 7 Chi.J.Int'l L.( 2007 ), p. 415.
- 23) A. Ibrahim, The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration, 23 Am. U. Int'l L. Rev.( 2008 ), p. 676.
- 24) Ibid.
- 25) Ibid., p. 677.
- 26) Supra FN 22, p. 412.
- 27) bid.
- 28) See supra FN 1.
- 29) Mc Millen ( supra FN 7 ), p. 98 .
- 30) ECB, The implementation of monetary policy in the euro area, chapter 6, 6.2.1 ( marketable assets ).
- 31) UK Financial Services and Markets Act, Order 2010, Art. 77A: the repayment of capital may be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income granted by them.