Sukukization: Islamic Economic Risk Factors in Shari'ah View

Alsayyed, Nidal

International Shari'ah Research Academy for Islamic Finance (ISRA), INCEIF the Global University in Islamic Finance, Internarional Islamic University, Malaysia (IIUM), Kuala Lumpur

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NIDAL A ALSAYYED

PhD Researcher Islamic Economics, Banking, and Finance

http://groups.google.com/group/nidal_islamic-finance

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INCEIF: the Global University in Islamic Finance, Kuala Lumpur
E-mail: nslsayye@iit.edu Telephone: + 6017 2559 700 (HP)

Profile: NIDAL ALSAYYED (http://ideas.repec.org/f/pal399.html)

ABSTRACT

Despite the Economic closeness of overall concept, *Sukukization (Islamic Securitization)* is not equal to "Securitization" as it is known in its conventional sense. Securitization, generally relates to the converting of loans of various sorts into marketable securities by packaging the loans into pools and then selling shares of ownership in the pool itself. *Sukukization*, on the hand; refers to, Islamic Sukuk Investment (as defined by AAOIFI) are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services.

The development of innovative Economic financial solutions in the Muslim world has been dormant for centuries. It is only recently, since the early 1970s that significant work that has been done in the field of Islamic Capital Market. In order to take benefit from Western financial structures, care must be taken to make sure that the concepts are acceptable by Shari'ah. The West has had significant success in linking the End-Investor (Excess Capital) with the most optimal user of this Excess Capital; be it the Stock Market, Debt Market or the Securitization structures, they all serve the purpose of linking Capital with its most optimal (on a risk-adjusted basis) user. It must be kept in mind, that even though the West has had more success than the Muslim world in implementation of a financial system, it has been plagued with constant cycles of boom and bust. The most recent financial markets crisis has again opened the discussion for the need of structural changes to the current financial models/instruments in place. Most commentators have stressed for the need of more regulation whereas the stress should be on making changes to the structural features of the financial instruments. An in-depth discussion of the financial system is beyond the scope of this article and for now the focus will only be on the Islamic Securitization structures (Sukukization) for the housing capital market and the relevant Economic factors (**Farhan, Malik 2010**).

KEY WORDS: Islamic Economics, *Sukukization*, Macroeconomics, Shari'ah Standards, AAOIFI, Islamic Economics, Securitization, SPV

ISLAMIC SECURITIZATION NEEDS MORE THOUGHT

Securitization is a process that has been heavily used by institutions offering Islamic financial services (IIFSs) in substantial volumes for many years, largely for the purposes of cash equivalence and tradability. In other words, *Sukukization* is process for an immediate liquidation, direct access to capital market, creation of secondary market, and risk segmentation — often referred to simply as sukuk.

The overall process will be arranged or 'securitized' by an SPV (Special Purpose Vehicle) structured by an IIFS. The pronouncement of Sheik Taqi Usmani (2008) declaring the bulk of the Sukuk issued in the market defied Islamic norms has stirred strong emotions. For some, it seemed to be rather hasty, not well-thought out and opposed to the needs of the Islamic capital market. In the view of others, however, it was no less than a very welcome and long overdue breath of fresh air for the industry. Some critics, who questioned the validity of the Sheikh Usmani pronouncement, argued that the personal view goes against the ruling of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) on the permissibility of sukuk as laid down under its Shari'ah Standard 13 (Resolution to the Fiqh Academy on Securitization) [1].

[1] Securitization by this definition falls within the prohibited debt securities about which Resolution No. 60 (6/11) was issued. It makes no difference to the ruling if the transfer of debts to the SPV occurs by the transfer of a right (*ḥawālah*) or by debt renewal or sub-participation. Secondly: *Taṣkīk,* which is mentioned in Resolution No. 13 (3/15), is the Sharīʿah-compliant alternative to securitization. It is done by the issuance of *ṣukūk*, which are based on *muḍārabah* for a project, or a particular investment activity, or on the basis of a *mushārakah* contract. The owners of the *ṣukūk* in this project do not receive interest or a fixed profit; rather, they will get a percentage of the profit generated from this project, according to the parameters mentioned in the Council's Resolution No. 30 (4/5) issued on *qirāḍ* (*muḍārabah*) bonds. Another alternative is *ṣukūk* based on an *ijārah* contract or some other permissible contract which can be the basis for a *ṣukūk* project with its special regulations for issuance and trade.

The view expressed in this article is that rather than contradicting each other, AAOIFI's Shari'ah Standard 13 on securitization and sukuk real application which is objected by well respected Shari'ah scholars whom are calling for real *Sukukization;* are actually both in agreement with each other, even though it may not have been explicitly stated.

A closer analysis reveals that the overall structures of sukuk as permitted by AAOIFI are theoretical models that are rarely or virtually never followed by the industry. Realizing this fact, rather than there being any conflict, Shari'ah scholars have simply put forward the same point of view, albeit expressed differently. In other words, their view points out what *cannot* be done, while AAOIFI reaffirms this and completes the picture by explicitly outlining in AAOIFI Shari'ah Standard 17 what *should* be done.

RISK FACTORS AND ELIGIBLE ASSETS FOR THE ISSUANCE OF SUKUK

In short, non Shari'ah compliant securitization cannot be structured if it does not fulfill the stringent conditions stated by standard 17 and 13 (AAOIFI). Thus, the key conditions laid out by AAOIFI Shari'ah Standard 17 are that sukuk to be tradable, must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally, in accordance with the guidelines, mentioned in AAOIFI Shari'ah Standard (21) on Financial papers.

A combination of a Musharakah and an Ijarah make up a single unit of a "Contract". This concept is elaborated using an example. **Person I** is interested in purchasing a house ("Home-Owner") but does not have enough Cash to make the purchase. **Person I** then goes to an Originator, who gets into a Musharakah with the Home-Owner to purchase the house.

In this example, both parties have ownership of the property that has been purchased. Both parties have risk to the depreciation of the house price and also chance to profit from potential appreciation in the value of the purchase property. The ratio of ownership in the property is equivalent to the ratio of the initial contribution percentage; initial Contribution of the Originator is the amount of contribution made by the Originator as a percentage of the total purchase price and similarly for the Home-owner. The result of the Musharakah is a symbiotic relationship between the Home-Owner and the Originator. Musharakah allows the Home-owner to purchase a property which he/she would not have been able to do without the partnership of the Originator.

Musharakah allows the Originator to serve as an Investor, we will describe in more detail later on how the Originator benefits from the partnership (**Farhan, Malik 2010**) .

Z = Total Purchase value of the house
I = Initial Contribution of the Home-Owner
Y = Initial Contribution of the Originator
Z = I + Y

The second leg of the Contract involves an Ijarah between the Home-Owner and the Originator. In this lease, the Home-Owner acts as the Lessee and pays the Originator (Lessor) for the Usufruct of Originator's share of the property. The rental rate used to form the Ijarah is derived from the market rates, which in turn are a product of a number of macro-economic factors. The Home-Owner has the option to make payments to partially purchase the Ownership of the Property from the Originator, it should be noted that it is an option not an obligation for the Home-Owner.

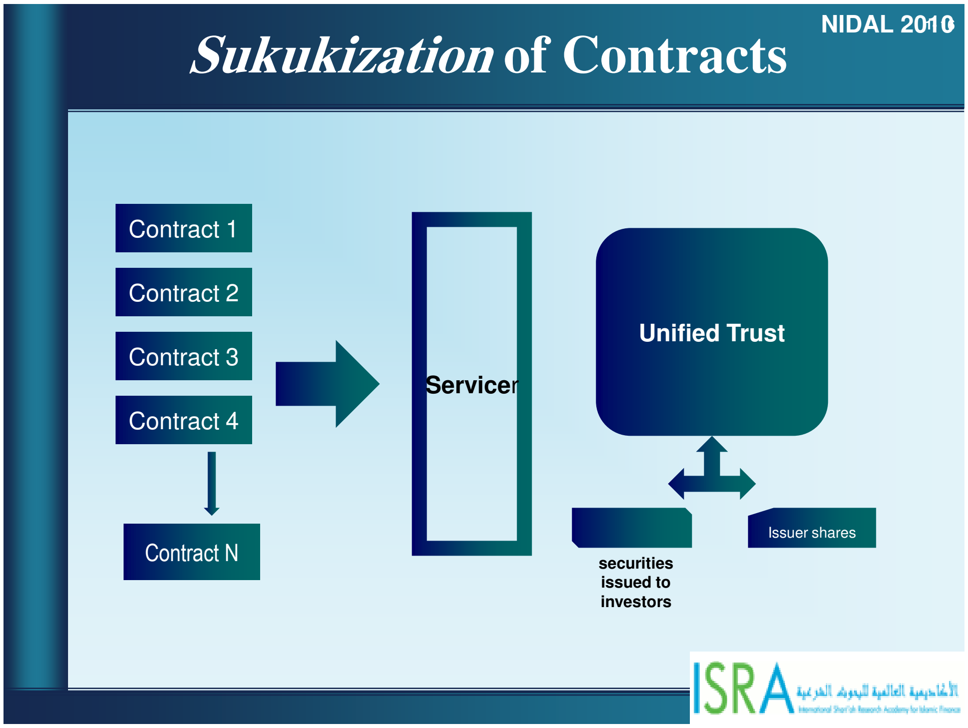
Since the lessor in Ijarah owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.(Muhammad Taqi Usmani, An Introduction to Islamic Finance), Next we show how the Ijarah is placed into a Securitization vehicle.

SUKUKIZATION OF CONTRACTS INTO UNIFIED TRUSTS

Musharakah and Ijarah are combined to form an individual Contract. These Contracts are then placed into a Bankruptcy-remote entity i.e. the Unified Trust. Figure 3 below shows the schematic showing a number of Contracts combined to form a Unified Trust. Servicer acts as an Agent on behalf of the End-Investors and Issuer to collect rent and principal payments from the Home-Owners. In return the Servicer charges a nominal fee which is paid from the rental payments made by the Home-Owners(**Farhan, Malik 2010**) .

Once the Unified Trust has been formed, it issues a number of Securities to End-Investors. The Securities that are issued by the Unified Trust form the Sukuk. Sukuk is backed by the ownership interest in the properties and the rental income is the periodic profit that is received by the Sukuk-Holders. The Issuer, which can be a Bank or a Finance Company, is responsible for originating the Contracts. The Issuer also keeps a share of the Unified Trust, in order to make sure that the Issuer and the End-Investors do not have any conflict of interest. Having the Issuer's share in the Unified Trust makes sure that the interests of Issuer and the End-Investors are aligned.

The figure below shows the complete frame-work of the proposed *Sukukization* structure. It begins with the Originator (Issuer) working with individual Home-Owners to originate the Contracts. These contracts are then placed into a Unified Trust which has ownership stakes in the purchased properties and receives periodic income from the Home-Owners. The Servicer is responsible for servicing all the payments in this structure and can be the same entity as the Issuer. The Unified Trust issues Sukuk securities which represent ownership stakes in the purchased properties and the rental income for the usufruct by the Home-Owners.



CONCLUSION & FUTURE OUTLOOK

The *Sukukization* structure proposed in this article behaves like a Hybrid of Agency and Non-Agency mortgages. It carries credit risk similar to Non-Agency mortgage but behaves like an Agency mortgage in terms of the vertical trenching.

In this article, a frame-work has been laid out for developing a *Sukukization* structure in order to finance the Home Mortgage Market. Effort has been made to address all the plausible issues relating to development of a housing market Islamic securitization vehicle. The structure is made to be completely in compliance with the injunctions of Islamic Shari'ah while at the same time taking advantage of the progress made in the Western world in developing a Securitization market (**Farhan, Malik 2010**).

There are still some factors that require more work. In case of significant appreciation of the property prices, it would always be in the interest of the Home-Owner to pay back the complete principal rather than refinance. Refinancing would entail sharing the property gains with the

Unified Trust. This issue can be addressed by limiting the amount of prepayment to a certain percent for each year without the option of carrying it forward to next year. As an example, if the term of the Ijarah is 5 years, then the maximum prepayment could be set at 20% per year. This would make sure that both the Home-Owner as well as the End-Investor both shares in the appreciation of the property price.

Development of a stable *Sukukization* structure for the housing market would immensely benefit both the home-buyers and property investors. It would provide home-buyers access to a reasonable and interest-free financing in order to purchase their homes. Having a Unified Trust as their Musharakah partner would provide additional security against the risk of default.

For the property investors it would allow them to make an investment into a relatively liquid product. It allows the investors to share in potential upside in property prices and at the same time provide stable periodic cash flows through the Ijarah.

A well refined housing market would attract global investors looking to make Shari'ah compliant interest-free investments. Such basic framework has been provided in this article, which can further be advanced to make it adaptable to the requirements of a certain country or region. I will be focusing in the next part on the trading of such *Sukukization* in the secondary market.

Wa'allahu A'alam,

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