

Understanding Islamic Securitisation

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Islamic finance structures are based on the precepts of the Shariah. Broadly speaking the Shariah is the body of Islamic jurisprudence that regulates various aspects of life including politics, economics, and succession. In the context of finance, the Shariah prescribes certain prohibitions, which constitute the main principles of Islamic finance. These prohibitions relate to charging of interest (Riba), uncertainty (Gharrar) in contracts, contracts relating to gambling (Qimar) and contracts pertaining to unethical investments. In addition, Islamic finance transactions are required to have a linkage to an underlying tangible asset (e.g. commodities, vehicles, real estate etc). In other words, an Islamic finance transaction will typically involve the sale of an asset, the lease of an asset or a joint venture or partnership in an operation or new business venture.

Islamic Securitisation

Islamic securitisation is a legal structure that uses the main principles of Islamic finance to achieve the economic purpose of transformation of non-tradable assets into tradable securities. Islamic securitisation relies on structural arrangements of asset transfer from the originator of the asset to a special purpose vehicle that will issue securities. The assets typically comprise of income generating financing arrangements entered into between financial institutions and their customers. These income generating financing arrangements can comprise of a portfolio of home financing contracts structured using Ijara financing, a vehicle finance portfolio structured using Murabaha or Ijara financing or participations in larger

syndicated financing transactions concluded using Shariah compliant structures.

Balance Sheet Treatment

One key commercial consideration for a financial institution seeking to undertake securitisation is to remove the relevant asset being securitised from its balance sheet and to book the proceeds received as income. This treatment is possible if the receivables are sold on a 'true sale' basis. Auditors usually require a legal opinion to confirm that a 'true sale' of the receivables has been effected.

The transfer is carried out on a true sale basis using either the legal concept of novation or assignment of rights. The procedures for carrying out a novation or assignment must be consistent with the rules of the jurisdiction where the assets (i.e. the ultimate obligors) are located. Therefore, if the obligors are located in the UAE, the procedures for carrying out a novation or assignment must be consistent with UAE law. The other features required to achieve the requisite balance sheet treatments are: (1) the assets transferred should be segregated into a bankruptcy remote vehicle such that the bankruptcy or the originator of the assets does not have an impact on the transferred assets; and (2) the originator should have no obligation to repurchase the transferred assets, in other words the transfer should occur on a 'without recourse' basis.

From a Shariah perspective it is difficult to segregate the receivables derived from the physical asset that generates the receivables. For example, as part of a home finance portfolio consisting of real estate Ijara transactions, the financial institution (originator) would hold the title to the real estate it has financed. In this example, the real estate would be transferred to the special purpose company (being the issuer of the Sukuk) and the Ijara agreement would also be novated in favour of the special purpose vehicle.

Understanding Sukuks

The most popular asset-backed securitisation structure within Islamic finance is Sukuk. In the Shariah Standard No. (17) on Investment Sukuk issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Sukuk is defined as "Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activities."

Sukuks are backed by Shariah-compliant assets that may take the form of Islamic financing methods such as Murabaha, Ijarah, Istisna, Salam etc.

Essentially, Sukuk structures involve a transfer of rights over receivables from certain Shariah-compliant assets from the originator (who seeks to securitise its assets) to a special purpose vehicle (acting as the Issuer). The investors provide the capital for the purchase of, or investment in, the Shariah-compliant assets against the issue of Sukuk Certificates by the Issuer SPV. The Sukuk Certificates represent pro rata share of the investors in the underlying Shariah-compliant assets. As a result, the investors are entitled to receive periodic payments derived from the Shariah-compliant assets.

Sukuk transactions may be structured in various forms. We will discuss the Sukuks based on Mudaraba and Wakala structures.

Securitisation: Mudaraba Structure

Sukuk with Mudaraba structure (Mudaraba Sukuk) would be feasible when there is a portfolio of different types of Shariah-compliant assets for example, real estate assets, non-real estate assets. The Mudaraba structure is similar to a joint venture where the investors appoint a manager to purchase assets from a financial institution. The manager is responsible for managing the assets.

The general concept of a Mudaraba is used as a base to structure the Mudaraba Sukuk transaction. The Issuer SPV will issue Sukuk to the investors against the payment of a subscription price. The subscription price received from the investors forms the Mudaraba capital which is provided by the Issuer SPV (as Rab-al-Maal/Trustee on behalf of the investor) to another SPV (acting as the Mudarib or manager) under a restricted Mudaraba Agreement. The Mudarib will use the Mudaraba capital to invest in a portfolio of Shariah-compliant assets, being the Mudaraba Assets, in accordance with the Mudaraba investment plan. This investment would involve the transfer of Mudaraba Assets, on a true sale basis, from the originator (as the seller of Shariah-compliant assets) to the Mudarib (acting as agent or trustee on behalf of the Rab-al-Maal and the Investors) under a Mudaraba Sale and Purchase Agreement.

The cash flow stream from the portfolio of Shariah-compliant assets is paid directly to the Mudarib who then makes a distribution to the Issuer SPV (as Rab-al-Maal/Trustee on behalf of the investor). The profits derived from the Mudaraba Assets will be shared between the Mudarib and the Rab-al-Maal in a pre-agreed profit sharing ratio under the restricted Mudaraba Agreement. The portion of Rab-al-Maal's profit will pass through to the investors on a pro rata basis. Essentially, the Sukuk represents undivided ownership of the Investors in the Mudaraba Assets.

Securitisation: Wakala Structure

The Wakala Sukuk structure is similar to the Mudaraba Sukuk structure, but with certain fundamental differences. Similar to the Mudaraba Sukuk structure, the Wakala Sukuk structure would be feasible for a portfolio of different types of Shariah-compliant assets.

Under the Wakala Sukuk structure, the Issuer SPV will issue the Sukuk to the investors against payment of the subscription price. The Issuer SPV (as Trustee) will enter into a Master Wakala Purchase Agreement with the originator (as seller of the Shariah-compliant assets) to purchase, on a true sale basis, the Shariah-compliant assets (forming the Wakala Assets). The subscription price from the issuance of Sukuk will be used to purchase the Wakala Assets.

The Issuer SPV (as Trustee) would appoint the originator as a Management Agent (or Wakeel) to manage the Wakala Assets for the benefit of the Trustee in accordance with the Management (Wakala) Agreement. Under the Management (Wakala) Agreement, the Managing Agent (Wakeel) would manage the Wakala Assets in accordance with the investment plan by providing certain services including timely receipt and payment of the Wakala revenues. The Wakala revenues are applied towards payment of the periodic distribution amount to the Investors as the Sukuk represents an undivided ownership interest in the underlying Wakala Assets and a right against the Issuer SPV for period payments of the profits.

The main difference between the Mudaraba Sukuk structure and the Wakala Sukuk structure is in respect of the profit sharing mechanism. Unlike a Mudaraba, in which profit is divided between the Mudarib and Rab-al-Maal based on pre-agreed ratios (which are then passed on to the Investors), in the Wakala Sukuk structure, the principal and the wakeel agree upon a profit return to the investors. Any profit in excess of the agreed profit for the account of the principal will be retained by the wakeel as a performance incentive.

Conclusion

Islamic securitisation transactions are growing in popularity in the Islamic countries. S&P reported that in 2018 the size of the Sukuk market was US\$114.8 billion and is expected to range between US\$105 billion to US\$115 billion. The major issuers of Sukuk are based in the six Gulf Cooperation Council ('GCC') states. A trend of sophistication in the understanding and structuring of Islamic securitisation transactions is clearly visible. Increasing numbers of regional and international banks, investment banks, asset managers are keen to participate in securitisation transactions. The relevant regulatory bodies are also keen to allow securitisation transactions subject to local legal and regulatory compliances and of course, Shariah approvals and are seen to work closely with the parties involved to pave way for the development of Islamic capital markets.

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