



# Stand and default

According to **Mohammed Khnifer**, recent Sukuk defaults could bring innovative restructuring approaches to the Islamic finance industry as the dilemma of restructuring forces scholars and lawyers to set aside differences and create Shari'ah-compliant restructuring plans

**W**hen there have been 21 confirmed cases of default events in the last 21 months, then you know that law firms are busy restructuring the defaulted Sukuk as well as saving those who are near to default.

When I initiated a series of research on the so-called defaulted Sukuk last year, many scholars I contacted told me that we would first have to wait and examine the cases. In other words, they needed some time to come up with innovative Shari'ah restructuring plans. The problem was that they had never seen large scale default events before; hence their task was how to make the conventional restructuring approaches Shari'ah-compliant.

Now for the first time, the Islamic finance industry has had a firsthand look at these details. Basically, there are three main approaches: haircut; extending the maturity of Sukuk addition by two or three years; debt/equity SWAP.

After examining most of these options, I believe: approach one does not guarantee the recovery of the principle. Worse, they will recover 70 – 80 per cent without any profits. Approaches two and three also do not guarantee the recovery of the principle, but it depends on the flexibility of the agreement after cancelling the original contact.

## HAIRCUT

Haircut is when the capital providers (i.e. Sukuk holders) agree to make a discount in order to get early settlement (Tanazul), according to AAIIFI standards.

Sometimes certificate holders are forced to go down the haircut route when the originator is in severe financial distress, i.e. there is hardly any cash flow from the underlying assets of the Sukuk (the asset-based type). Therefore, extending the maturity of the Sukuk is not an option.

To give an example from the conventional financial system, Argentina offered last month 66 per cent haircut on its defaulted bonds. Same thing with Dubai World, which may ask banks to take a 20 per cent "haircut" from the face values on their loans.



### EXTENDING MATURITY

Certificate holders opt for this approach when the financial position of the company is too strong. Nonetheless, this will raise the issue of opportunity cost for the Sukuk holders. Should the same situation happen with bonds, the originator will increase the interest rate on the coupon payment in order to compensate them for the opportunity cost. However, with Sukuk, this is not permissible. So, the question is to come up with a Shari'ah-compliant solution for the opportunity cost?

It depends on the nature of Sukuk. If they are Ijara Sukuk then extension means extending the lease contract, which can be on new conditions which may include higher rent. If they are Musharakah Sukuk, then the term can be extended and the ratio of sharing profit may be changed.

For instance, Nakheel, the builder of the palm-shaped islands off Dubai's coast, plans to issue bonds in mid-July to settle its debt to contractors. The company said in March that trade creditors would be offered 100 per cent recovery of their claims – 40 per cent through a cash payment and 60 per cent through a publicly tradable Sukuk, paying a 10 per cent return annually. In my view, Nakheel decided to pay this high rate of return in order to compensate the Sukuk holders for the opportunity cost.

### DEBT-FOR-EQUITY SWAPS

In a debt-for-equity swap, a company's creditors generally agree to cancel some or all of the debt in exchange for equity in the company. Debt for equity deals often occur when large companies run into serious financial trouble, and often result in these companies being taken over by their principal creditors.

This is where we see Shari'ah restructuring innovation coming into play. At the 7th Kuala Lumpur Islamic Financial Forum 2010 (KLIFF 2010), Dr. Mohamed Daud Baker spoke about debt/equity swaps. He said that the "Sukuk can be converted into equity of the issuer".

Personally, I think what he meant by the issuer is the originator as the issuer is the SPV. My interpretation to his brief statement is that Sukuk is not debt, it is equity as you take ownership in the underlying assets. In case of default, you can convert equity (of the underlying assets) into another form of equity (of the originator) at a formula agreed to both parties.

Dr Mohamed Elgari concurs with my interpretation. He said, "Since the Sukuk holders do own assets which can be sold to the originator or the third party then they can use the value to purchase shares (i.e. convert to equity) of the originator who is now the purchaser of these assets."

As we explore the restructuring approaches for any defaulted Sukuk, one should mention

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the choice of replacing the old securities with new issuance. For example, you can issue new Sukuk in order to repay or redeem the old Sukuk.

The Sukuk industry is on its way to maturity, despite the fact that there is a need to educate investors on these sophisticated instruments. The industry needs to recognise, as well the next generation of Islamic bankers, the vital role that needs to be filled in Sukuk origination.