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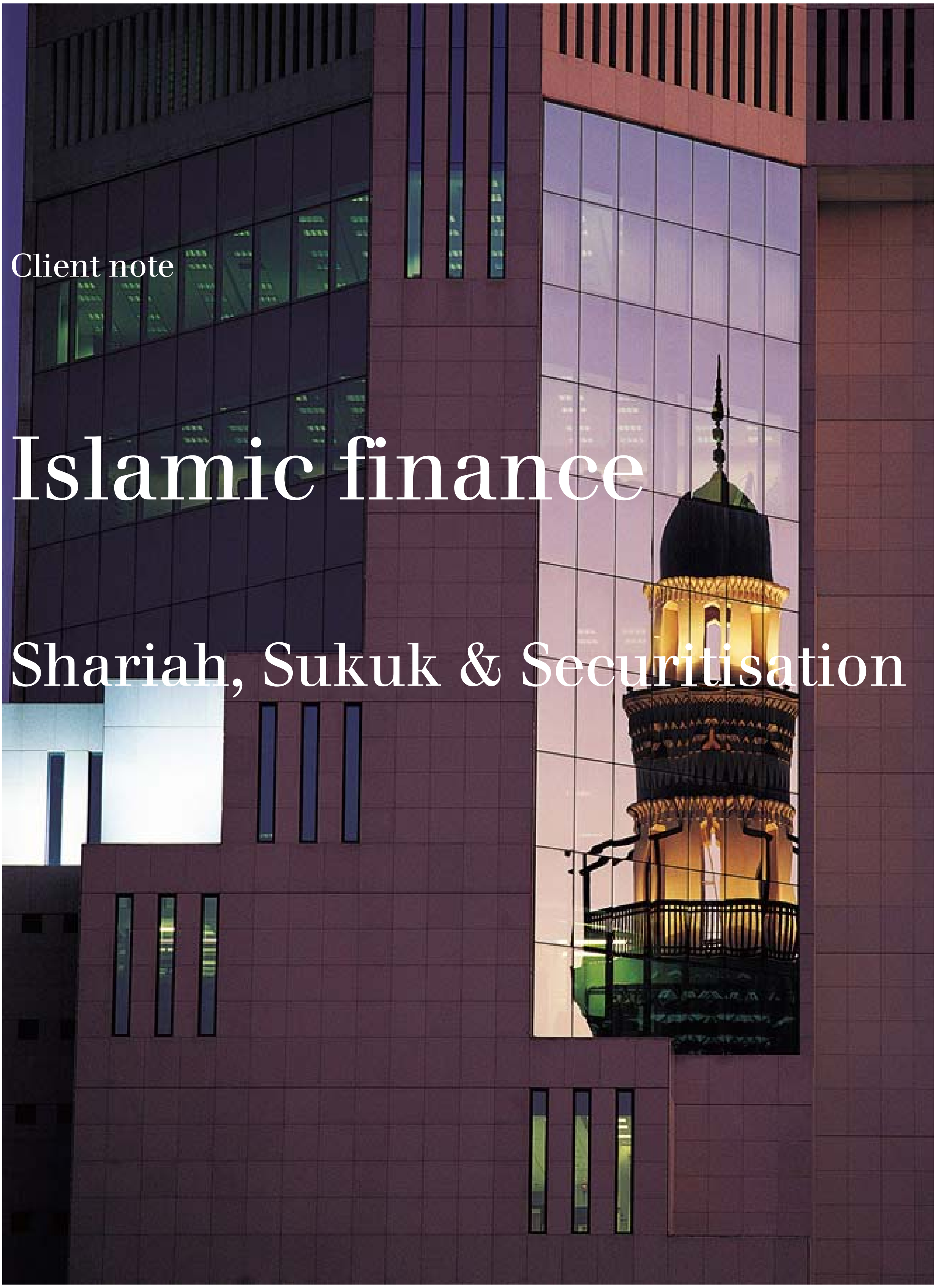
Client note

Islamic finance

Shariah, Sukuk & Securitisation



Contents

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1. Introduction

Total assets within the Islamic banking industry are presently estimated to exceed $200 billion and Islamic financial institutions more generally are continuing to experience substantial growth in business turnover.

Over some 25 years a variety of financial institutions have developed sophisticated methods to advance capital to both the private and public sector in a manner compatible with Shariah. However, it is only recently that tradable Shariah compliant financial investment instruments have come to market in substantial amounts. In this respect, the development of an Islamic bond market has been the primary area of growth, providing an avenue for the short and medium-term placement of funds by investors. The growth of this market has not only been fuelled by the desire of corporates to raise Shariah compliant funds but also by investor demand for Shariah compliant products. Recently a European federal institution, with no Islamic constitutional links, has begun to issue Shariah compliant securities to attract Middle Eastern investors. Such investor appetite for more straightforward securities is expected in turn to fuel the growth of a Shariah compatible securitisation market. In 2004, three Shariah compliant securitisation deals have come to the market.

This note begins by discussing traditional Islamic financing methods. It then focuses on the development of the Sukuk and Shariah securitisation market, discussing suitable Shariah compatible securitisation structures. Finally, it outlines some of the hurdles which will need to be overcome for this market to flourish.

2. Shariah

Islam is a system of belief that encompasses not only man's relationship with God, but also provides Muslims with a code that regulates their entire way of life. The Qur'an sets out its notions of equity, justice, fairness, morality and many other values which underpin the entire Islamic system.

The Qur'an states that God created, and owns everything. Man, therefore, holds wealth on trust for God and must carry out his duties as trustee in the manner prescribed by God. These duties are found in the Islamic Law (*Shariah*).

Shariah is derived from, *inter alios*, the Qur'an. However, it is not a codified body of law. It is, by virtue of its derivation, capable of development and interpretation. When a new issue arises on which the position of the Shariah is unknown, it may be necessary to seek a legal opinion (*Fatwa*) from a religious scholar (*Mufti*). The opinion of different *Muftis* may differ on the same issue depending on which of the five major Islamic juristic schools they belong to and according to their individual interpretation of the Shariah.

An Islamic financial institution will have a committee made up of senior officers and religious scholars which evaluate whether certain transactions conform to Shariah. Each Shariah committee will form its own view as to the acceptability of a particular transaction. Consequently, a transaction may be found by the Shariah committee of one Islamic financial institution to be permitted but may be considered prohibited by the Shariah committee of another Islamic financial institution or even by potential investors in the financial instrument.

3. Introduction to Islamic financing

Islamic financing is not tied to any particular jurisdiction, but it can take place anywhere in the world where there are Muslims who wish to engage in financing transactions in a manner consistent with their faith.

One of the fundamental principles governing Islamic financing is that the receipt of interest is prohibited. This is categorically stated in the Qur'an:

"*Those who devour Riba (interest) will not stand except as stands one whom the devil hath driven to madness by (his) touch*" *(II:275)*

الَّذِينَ يَأْكُلُونَ الرِّبَا لاَ يَقُومُونَ إِلاَّ كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ
الشَّيْطَانُ مِنَ الْمَسِّ ذَلِكَ بِأَنَّهُمْ قَالُواْ إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا وَأَحَلَّ
اللّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا فَمَن جَاءهُ مَوْعِظَةٌ مِّن رَّبِّهِ فَانتَهَى فَلَهُ مَا
سَلَفَ وَأَمْرُهُ إِلَى اللّهِ وَمَنْ عَادَ فَأُوْلَـئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا

In an investment environment, Riba is interpreted as any return on money that is predetermined in amount and therefore includes modern day interest-based financing. Islamic principles allow instead for the replacement of interest by a return that is dependent upon the profitability of the underlying investment. In addition, Islamic principles permit the financing of sales by means of deferred payment at a premium to the spot price. Modern scholars have also encouraged asset-backed finance where the return to the financier is linked either to the provision of an asset to the client or to the acquisition of an asset from the client. In all of the above a clear linkage emerges between the earning of returns and the assumption of risk.

In particular, Shariah prohibits transactions in which some or all of the following elements are present:

- uncertainty (*gharar*) in contracts – there is a prohibition on the sale of items whose existence or characteristics are not certain, and upon contractual terms that are ambiguous or unclear. This may mean that certain contracts containing obligations to insure another person or to grant an option to purchase an asset may be unacceptable.
- Gambling (*maisir*) – may apply to dealings in futures and options to the extent that they are speculative.
- Prohibited (*haram*) commodities and activities – this involves a blanket prohibition on involvement in activities relating to the provision of pork, alcohol and gambling services, among others. Nevertheless, different views exist on borderline cases such as hotels or aircraft in which, for example, alcohol may be served.

Various Shariah compliant financing and investment structures have been developed. Four of the most commonly used structures are:

- Murabaha (Sale at an agreed profit margin)
- Mudarabah (Participation financing) and Musharaka (Equity participation)
- Ijara (Leasing)
- Sukuk (Islamic bonds).

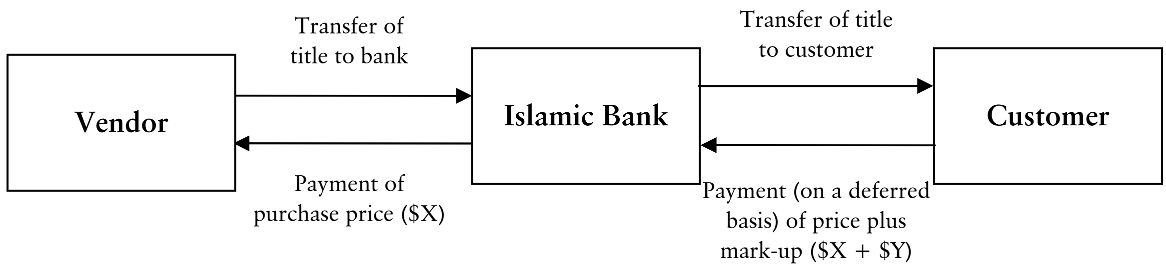
4. Islamic financing structures and Sukuks

4.1 MURABAHA

Murabaha is one of the most common forms of Islamic financing, and although it is most applicable to trade financing transactions requiring liquid short term instruments, it can also be used for longer term investments. As it is used in the modern context, murabaha involves the purchase of a specific commodity by a financial institution upon the request of a client. This client then purchases the commodity from the financial institution under a deferred payment arrangement that is designed to cover the costs of purchasing the commodity and an agreed upon mark-up. This mark-up constitutes the bank's profit and has been widely used as a substitute for the charging of interest by institutions that wish to adapt interest-based banking to Islamic requirements. The calculation of the mark-up or profit may be in the form of a fixed lump sum or it may be calculated as a percentage (often not dissimilar to the market rate of interest at the time) of the financed amount.

This type of financing complies with Shariah because the financial institution initially takes title to the commodity, and is therefore buying and selling the commodity at a risk to itself as well as to the buyer.

Murabaha



Notes

A. The financial institution ("**Islamic Bank**") purchases the asset from the vendor for $X.

B. The "**Customer**", who would be the borrower in a conventional borrowing, purchases the asset from the Islamic Bank at a price plus a mark-up ($X+$Y), which is payable on a deferred payment basis.

C. The period covering the deferred payment is effectively the period of the financing.

D. Title to the assets is transferred to the Customer at the time of purchase but the Customer will provide the same or other assets as collateral to the Islamic Bank for the period of the financing.

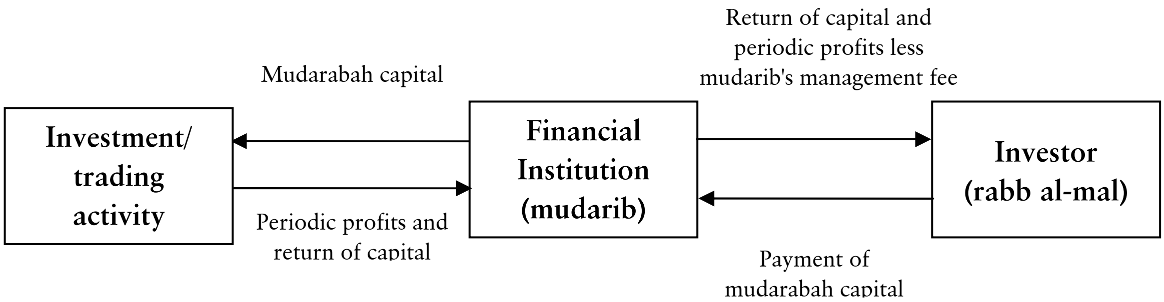
4.2 MUDARABAH & MUSHARAKA

Mudarabah is a special form of partnership (*Musharaka*), that has been deployed by modern Islamic financial institutions to provide fund management services. In line with the Islamic principles of risk-sharing and profit-sharing, it is characterised by one party (*rabb al-mal*) entrusting his money to another party (*mudarib*) who is akin to a fund manager and who contributes to the arrangement by providing the necessary experience and management expertise. The *mudarib* will utilise the money in an agreed manner, and will subsequently return the principal and a share of the profit to the *rabb al-mal*, retaining a pre-agreed share of the profit for him.

The important principles to note are (i) the division of profits must be on a pre-agreed proportional basis; (ii) if a loss occurs then the *rabb al-mal* will not usually face liability beyond the loss of principal; and (iii) the *mudarib's* liability will generally be confined to the loss of his time and effort.

Mudarabah may be entered into for a single investment or on a continuing basis with the financial institution acting as a fiduciary. Mudarabah investments may be made for fixed terms and arranged through negotiable instruments (called investment deposit certificates or Mudarabah certificates) and in such situations may have characteristics akin to shares.

Mudarabah

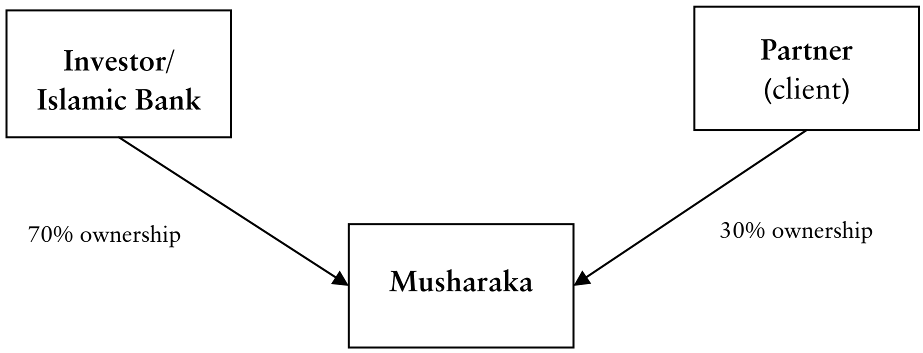


Notes

A. Investors provide the *Mudarib* (Financial Institution) with capital to fund a specified enterprise.
B. The *Mudarib* does not contribute capital but contributes management expertise only.
C. The *Mudarib* is responsible for the day-to-day management of the investment and is entitled to deduct its management fee from the profits. The balance of the profit is payable to the investor.
D. If the investment makes a loss, the investor (as the investor provides the funds) has to bear all losses unless the loss has resulted from the negligence on the part of the *Mudarib*.

In the common form of Musharaka, by contrast, both parties supply working capital. Here, the contractual conditions are flexible enough to allow the creation and sale of participation notes to the investors or Islamic Bank who provides the funding which represents their share of the investment. The technique is therefore suitable for joint venture investments and can be used to package portfolios of assets whose returns, real property lease payments for example, are subsequently shared among the partners.

Musharaka



Notes

A. The client and the investor contribute toward the capital of the enterprise in the agreed proportions.

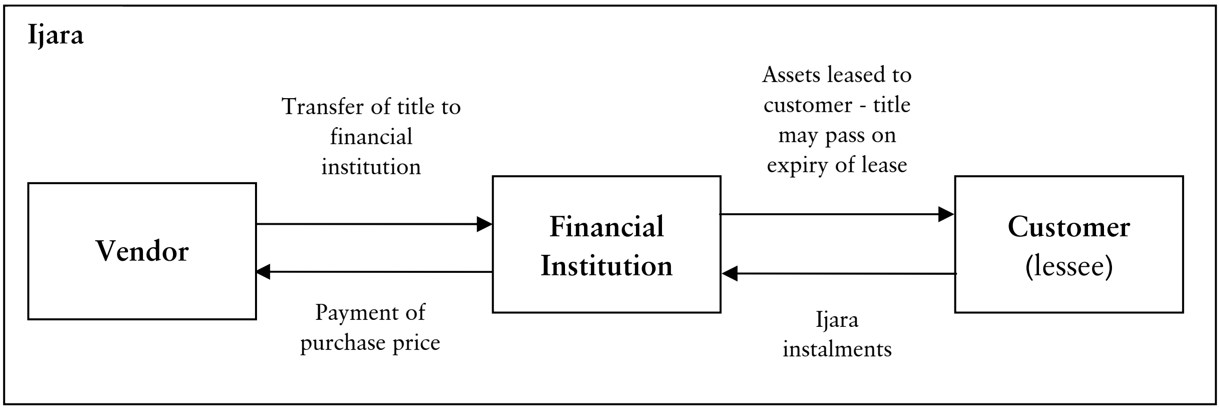
B. Under a "diminishing" Musharaka, the client will buy out the financial institution share over a period of time.

C. The client and the financial institution share in the profits according to the agreed proportions, which may be different from the proportions of capital contributed. Likewise losses will be borne by the client and the financial institution according to their capital contributions.

4.3 IJARA

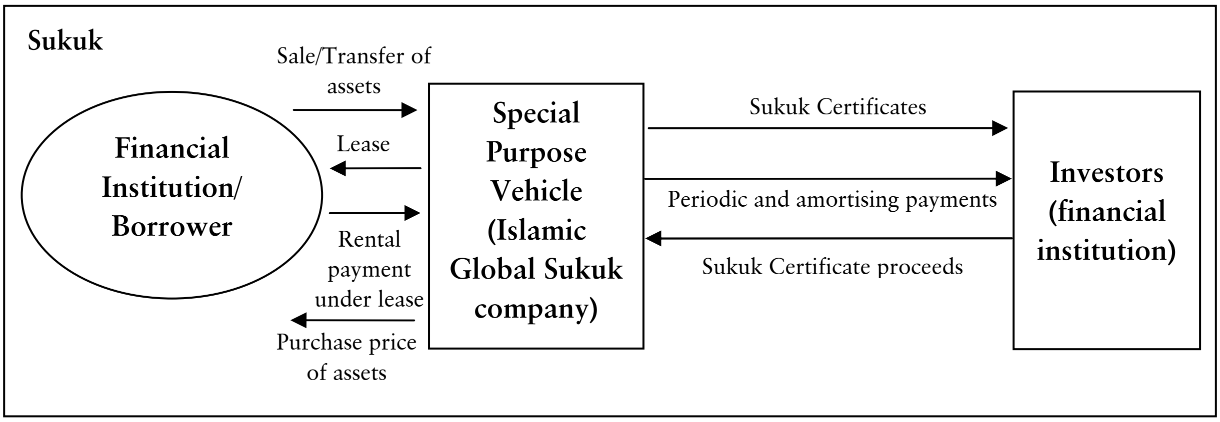
Ijara shares many similar characteristics to lease financing and hire-purchase arrangements. It involves a lessor (usually a financial institution) purchasing an asset, and renting it to a lessee for a specific time period at an agreed rental or receiving a share of the profits generated by the asset.
There are two main types of lease under the Ijara structure. The first involves a longer term lease which usually ends with the transfer of ownership of the asset to the lessee (*Ijara wa lqtina*), as in a modern finance lease. The second type of lease is for a shorter term and will usually end with the financial institution retaining ownership of the asset, in common with an operating lease. The rental income in this second type of lease will take into account wear and tear of the asset.

To comply with Shariah, the leased assets must not be prohibited items (for example, machinery for the manufacturing of alcohol) and must be used in ways deemed lawful by Shariah.



4.4 SUKUK

A Sukuk represents proportionate beneficial ownership and may be described as an Islamic bond. For a defined period the risk and return associated with cash flows generated by a particular asset belong to investors (*Sukuk holders*). The characteristics of a Sukuk are similar to a conventional bond with the difference being that a Sukuk is asset backed.



The growth of the Sukuk market may be attributed to the potential that it provides for liquidity management, which has been identified as one of the key ingredients necessary for the further development of the Islamic banking and finance industry. Under modern jurisprudence, Shariah prohibits financial institutions from trading short-term debt instruments at anything other than face value, or from drawing upon established interbank money-markets. A consequence of such prohibitions has been that Islamic financial institutions have maintained highly liquid balance sheets with limited investment opportunities for their assets. Sukuks have, over the past two years, created new possibilities for the short and medium term placement of funds.

Sukuks must be asset-backed and are often structured as bundles of Ijara or leasing transactions, especially where the ability to trade on a secondary market is required. Backing by real assets ensures that a Sukuk is tradable, whereas one that is structured around a pure receivable (arising for example under a murabaha sale) may encounter the Shariah prohibition on debt trading mentioned above.

To issue a Sukuk, a financial institution or other entity (such as a sovereign) will typically incorporate a special purpose company, an Islamic Global Sukuk Company (IGS). The IGS issues Sukuk certificates to investors and uses the proceeds raised to purchase a rental generating real property or other cash generating asset from the financial institution or other entity. The IGS in turn leases the property or asset back to the financial institution or other entity for a period corresponding to the duration of the tenure of the Sukuk certificates with the property or the asset being held on trust for the Sukuk holders. The rental payments due from the financial institution or other entity to the IGS will exactly match the periodic payments under the Sukuk holders. These rental payments may be fixed, or under more recent jurisprudence, calculated with reference to the inter bank offered rate plus a margin which represents the market rate for rental payments. In structuring such transactions it is important to note that all amounts due to the IGS, including the rent that will fund the periodic payments under the Sukuk certificates are direct, unconditional and irrevocable obligations of the financial institution or other entity. The financial institution or other entity is obliged to purchase from the IGS the asset or property upon the maturity of the lease at an agreed price which will be used for the repayment of the principal to the Sukuk holders.

The following trades are examples of this recent trend towards sovereign borrowers and corporates participating in the Sukuk market:

- State of Bahrain's $250 million Sukuk issued in 2003, which was backed by an Ijara lease on the country's airport.
- Government of Malaysia Global Sukuk in 2002, which was backed by an Ijara lease on a single piece of government property.
- State of Qatar Sukuk issued in 2003 (described in detail in the next section) in which the proceeds were partly used to finance the construction of the Hamad Medical City.
- Bahrain-based Liquidity Management Center for Emaar Properties of Dubai Sukuk issued in 2003, in which the proceeds were used to fund Emaar's expanding portfolio of new commercial and residential projects in and around Dubai.

In the past two years alone $6billion worth of Sukuk certificates has been issued. Although the market is still in its infancy, it is developing at significant pace. The government of Bahrain is committed to replace its short-term conventional debt programme with medium term Sukuks. The diversification of the State of Qatar's sources of funds shows promise for future issues of Sukuks. The Islamic Development Bank has taken a policy decision that, rather than looking to its shareholders for capital, it intends to raise an additional $4 billion largely through the issue of Sukuks. Turkey, Pakistan and Iran are also understood to be examining the Sukuk structure and transactions from those jurisdictions are expected to come to the market within the coming few months.

The market will only mature when corporate Sukuks are issued with regularity, and for this to happen a viable secondary market needs to be developed. At present only a small proportion of Sukuks are traded, with most investors taking a buy and hold approach. However, as more Sukuks are issued, investors may be tempted to trade Sukuks so as to generate greater returns on capital invested and to create liquidity. The Bahrain Marketing Agency (*BMA*) is encouraging local banks and private institutions (both inside and outside Bahrain) to issue Sukuks and is offering to purchase Sukuks from Islamic financial institutions on a short-term basis. Such "repo" transactions are aimed at assisting Islamic financial institutions in managing short-term liquidity.

Developments such as these should encourage the Shariah compliant structured finance market to grow. What is most encouraging is that the Sukuk market is no longer the sole preserve of Islamic Issuers or investors. For example, 48 percent of the Qatari Sukuk was subscribed for by conventional investors, including 24% from institutional investors, 11% from fund managers and 13% from central banks and government institutions. Indeed, the German state of Saxony Anhalt recently issued a $120 million Sukuk. The intent was two fold as the regional finance minister outlined:

> "*On the one-hand.... economic reasons. There are investors out there and it makes sense to provide them with a product. On the other hand it is a matter of international courtesy. We want to send out a message of respect for other cultures who have different regulations on investing.*"

4.5 SUKUK CASE STUDY - QATAR GLOBAL SUKUK

Introduction

The transaction involved Qatar Global Sukuk (*QGS*) (a joint stock company incorporated in Qatar owned jointly by the government of the State of Qatar and HSBC Bank Middle East Limited) issuing rated Sukuk certificates, the proceeds of which were used for general funding purposes by the government of the State of Qatar. QGS was solely established to issue Sukuk certificates and to act as trustee for the Sukuk holders.

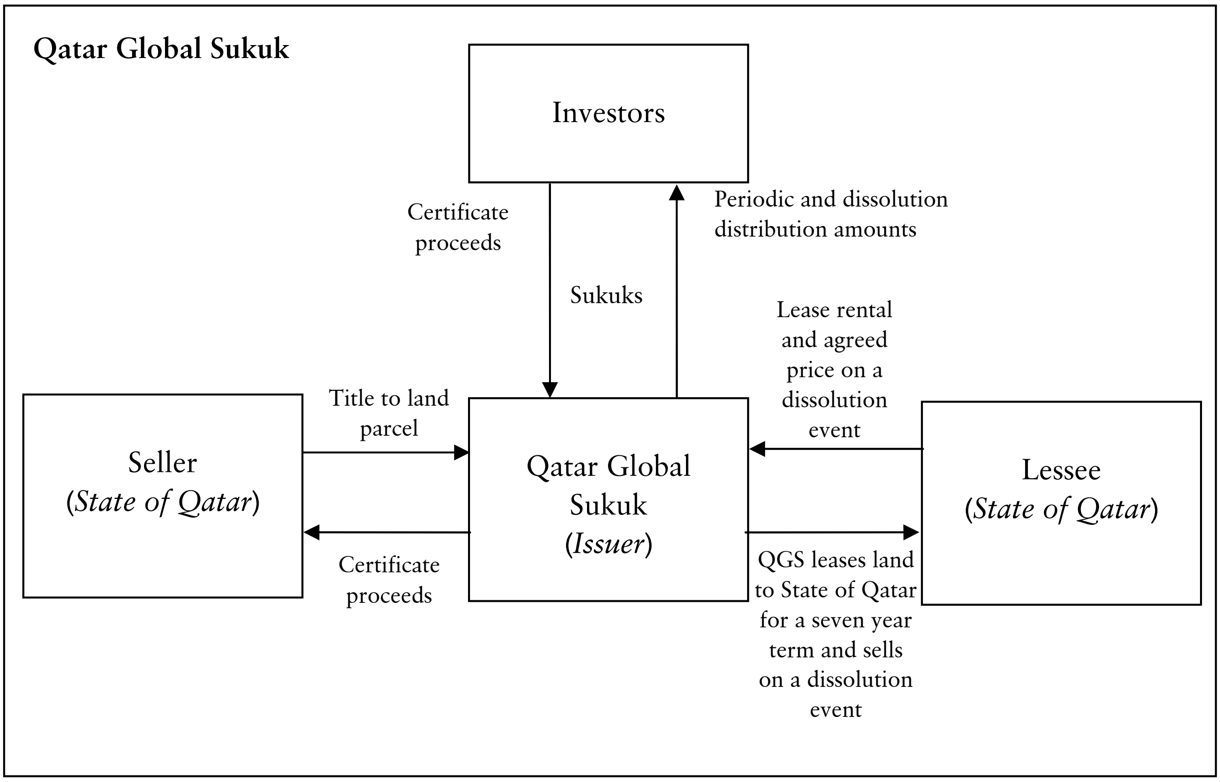
Structure

QGS purchased land from the State of Qatar, which in turn was leased by QGS to the State of Qatar for seven years (corresponding to the tenure of the Sukuk certificates) under a lease agreement. The purchased land excluded existing buildings and fixtures constructed upon it. All acquisition costs (relating to the purchase of the land) and costs of any construction on the land were paid by the State of Qatar. The purchased land and rental income from the lease was held on trust for the Sukuk certificate holders. The lease rental payments from the State of Qatar are made pursuant to an Ijara agreement between the State of Qatar and the QGS and exactly match the periodic distribution payments payable under the Sukuk certificates. The lease rental payments are calculated by reference to a benchmark which is loosely related to six-month US dollar LIBOR plus a margin.

The State of Qatar, in its capacity as the lessee, agreed that payments under the lease would not fall below a minimum amount. Should a dissolution event occur, the Ijara agreement would be terminated and the State of Qatar, pursuant to an agreement it made at the beginning of the transaction, would be required to purchase the land from QGS at an agreed price. Dissolution events include default by QGS to the Sukuk holders, default by the State of Qatar under the Ijara agreement or any of the transaction and any illegality which renders any of the State of Qatar's or QGS's obligations unlawful. The agreed price is calculated with reference to the purchase price less an aggregate of all amortisation payments paid under the Ijara agreement. Such purchase price would fund any dissolution payments under the Sukuk certificates.

The QGS "floating rate" Sukuk certificates are rated and reflect the long-term rating on the State of Qatar for the following reasons:

- all amounts due to QGS, including the lease rentals payable by the State of Qatar under the Ijara agreement, match and fund the distribution payments under the Sukuk certificates. These payments are direct, unconditional, unsecured, and general obligations of the State of Qatar and rank at least pari passu with all other unsecured and unsubordinated obligations of the State of Qatar. These lease rental payments are irrevocable.
- Should a "dissolution event" occur, the dissolution amount payable on the Sukuk certificates is an obligation which is dependent on the State of Qatar. Payment of the dissolution amount is secured by an irrevocable undertaking by the government of the State of Qatar to purchase the land from QGS at an agreed exercise price.
- The issuer, QGS, is a special purpose vehicle with the single objective of issuing Sukuk certificates. This should ensure that all payments made by the government of the State of Qatar to QGS would in turn be available to make payments to Sukuk certificate holders.


Qatar Global Sukuk
Investors
Certificate proceeds
Sukuks
Periodic and dissolution distribution amounts
Lease rental and agreed price on a dissolution event
Title to land parcel
Seller
(State of Qatar)
Qatar Global Sukuk
(Issuer)
Lessee
(State of Qatar)
Certificate proceeds
QGS leases land to State of Qatar for a seven year term and sells on a dissolution event

5. Securitisation

There are two driving forces behind the development of the Shariah compatible securitisation market. The first is a growing demand by investors for Shariah compliant financial instruments. The other is the desire of corporates to raise funds in a cost effective, Shariah compliant, manner which does not dilute shareholder equity. Securitisation is a particularly appropriate tool in the financing basket for companies based in the Middle East and North Africa (*MENA*) region for the following reasons:

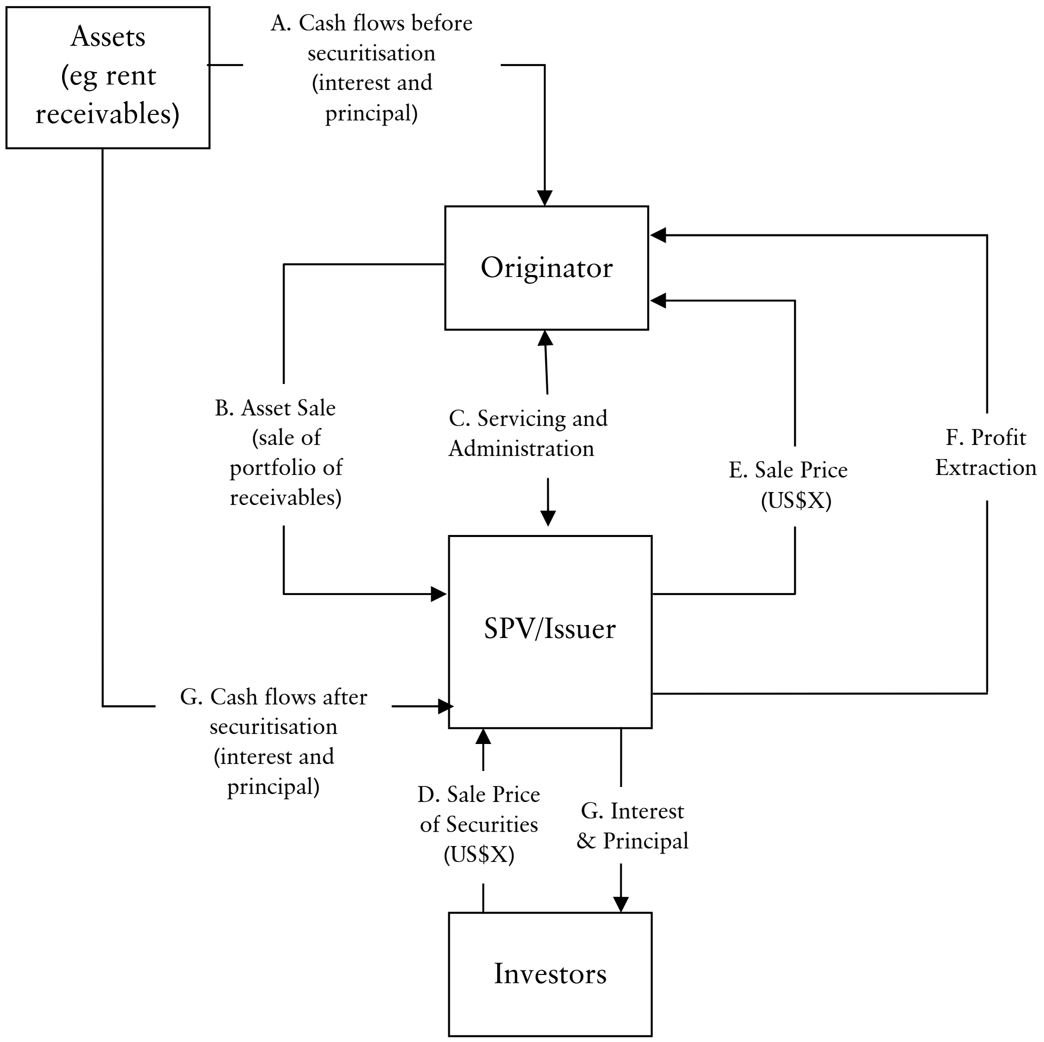
- it is not uncommon for companies in this region to have a high percentage of current assets on their balance sheets – the figure of 30 to 40% of total assets is not atypical.
- These current assets can be transferred.
- Securitisation neither impacts on the capital structure of the company nor does it increase debt/gearing ratios. Rather, arguably, it improves return and liquidity ratios. In essence it "cleans up" a balance sheet.
- Securitisation may provide a cheaper source of funds from the capital markets than syndicated debt, which may be reserved for strategic investments where it is not suitable for the capital markets to be tapped.

5.1 SECURITISATION - AN OVERVIEW

Securitisation is a method of funding a variety of receivables, including mortgage debts, leases and loans. It involves the issue of bonds in which the payment obligations under the bond are secured against a portfolio of receivables and its related cash flow stream. The bonds are freely traded and are generally rated.

The basic technique requires the rights over the receivables to be transferred from the owner (*Originator*) to a special purpose vehicle (*Issuer/SPV*). The SPV then issues bonds and incorporates into the securitisation structure certain credit enhancing features.

There are numerous securitisation structures that are commonly used in the conventional market. Each structure typically shares features that are shown on the diagram below:



Notes

A. Assets are accumulated by the Originator and funded on the Originator's balance sheet.

B. Once a critical mass of assets has been attained (*Portfolio*) these are then sold/assigned to an SPV, which is established for the specific purpose of funding the assets. The SPV may be owned by a charitable trust, or on certain occasions by the Originator.

C. Servicing and administration of the assets is then sub-contracted back to the Originator by the SPV.

D. The SPV issues tradable debt securities to fund the purchase of the Portfolio. The performance of these securities is directly linked to the performance of the assets – and there is no recourse (other than in the event of breach of contract) back to the Originator.

E. Investors will purchase the securities because they are satisfied (normally by relying upon a rating) that the securities will be repaid on the maturity date from the cash flows available in the asset pool. A considerable amount of time is spent considering the different likely performances of the asset pool, and the implication of defaults by borrowers on the corresponding performance of securities. The proceeds upon the sale of the securities are used to pay the Originator.

F. The SPV agrees to return any surplus cash flow which arises during the tenure of funding back to the Originator by virtue of servicing agreement or other profit extraction methods.

G. Cash generated by the assets is used by the SPV to meet obligations under the debt securities.

5.2 SHARIAH SECURITISATION

Islamic financing generally requires the advancement of funds to be linked to the performance of various types of assets. This is a typical feature of securitisation.

To comply with Shariah, the nature of the assets being securitised and the scheme of arrangement between the originator and lender must both comply with Shariah. The laws governing compliance with Shariah for both these aspects were discussed previously but it is worth pointing out that conventional mortgages and credit cards, which are typical conventionally securitised assets do not comply with Shariah, as they are interest-bearing loans. There is a blanket prohibition on interest under Shariah.

The underlying asset pool or portfolio of receivables in a securitisation should, in essence, match one of the accepted Islamic financing schemes. For example, in the securitisation of the following asset classes the underlying Islamic financing structure referred to may be utilised:

- *inventory and trade finance securitisations*
  The underlying structure might be construed as a Murabaha contract. The SPV would be purchasing goods and selling them at a pre-agreed profit margin, rather than having a pool of interest-bearing loans.
- *Equipment securitisations*
  This would involve leases or leased-back underlying assets and could be arranged as Ijara contracts.

5.3 STRUCTURING SHARIAH SECURITISATIONS

From an examination of the prevalent structures in the securitisation market, in general the structure referred to as "pass through" satisfies Shariah with little modification.

The pass through structure facilitates direct ownership by investors in a portfolio of assets, which are similar in terms of maturity, yield and quality (*Portfolio*). The originator will service the Portfolio, make collections and pass revenues to the investors with the deduction of a servicing fee. As the Portfolio is owned collectively by the investors, this structure is not a debt obligation of the originator and will not appear on the originator's balance sheet. The securitisation may be structured so as to represent an assignment of a portion of ownership rights and obligations over the Portfolio, but not a conveyance of title. Whether such a structure is adopted will depend on tax or investor issues, for example local legislation in some MENA countries prohibit and restrict foreign ownership of locally domiciled assets. Consequently, partial assignment without the formal transfer of title may circumvent this prohibition.

For a structure to comply with Shariah, some degree of ownership must be transferred to the investor. Transfer of registered title is not necessary, rather a collection of ownership rights that would allow the investors to perform duties related to ownership (if desired) or rights granting access (subject to notice) over the asset would be sufficient to satisfy Shariah. Such access may allow investors to cure a defect caused by the servicer or issuer, or even result in the investors being able to take over operations from the servicer if circumstances dictate. Such rights and obligations might ultimately empower the investor to take control of the assets and sell them. The level of conveyance varies for practical reasons from jurisdiction to jurisdiction, but a minimum level of conveyance is required to avoid characterisation as a secured loan by Shariah scholars.

An overriding Shariah rule needs to be kept in mind when structuring securitisation transactions, namely all conveyances must be completed simultaneously where they originate from the same document. In an interest bearing securitisation, two securities may be derived from a single lease – a principal-only instrument governed by the contract of lease (and related security instrument), and an interest-only instrument governed by a promissory note. This practice is prohibited by Shariah. In essence, financial institutions may not derive multiple interests from an asset in a manner that creates either the sale of a debt, sale of an isolated cash flow or a direct interest equivalent obligation.

Credit enhancement

Securitisation structures build in credit enhancement techniques so as to achieve a higher rating and lower the cost of funds. Tranching is a common technique which may be easily adapted to comply with Shariah. In a traditional securitisation structure, the SPV issues multiple classes of notes. For the purpose of this note, it is assumed that only Class A and B Sukuk Certificates are issued. The Class A Sukuk Certificates have priority over the Class B Sukuk Certificates for the payment of principal and any profit return payments under the Sukuk Certificates. The originator retains the Class B Sukuk Certificates, which are subordinate to the Class A Sukuk Certificates. The SPV receives the cash flow deriving from both classes of notes and distributes them according to the order of payment priorities defined in the transaction documentation: first to Class A Sukuk holders and then to Class B Sukuk holders. This will bolster the rating of the Class A Sukuk Certificates, which will be supported by the cushion provided by Class B Sukuk Certificates.

This effect can be legitimately achieved in compliance with Shariah by assigning the full ownership rights of all the assets in the Portfolio to Class A Sukuk holders with lesser rights, for example, rights of access being conveyed to the holders of Class B Sukuk holders. There will exist in this situation a lease back agreement with the issuer for the entire Portfolio with fixed rental payments. The issuer will also be granted an option to buy back the Portfolio at a predetermined price on a future date. The sale price and the rent are fixed on the issue date in order to ensure that the Class B Sukuk certificates holder receive a fair market value for the risks taken, which will be greater than the return received by the holder Class A Sukuk Certificate holders.

Caution needs to be exercised with other forms of credit enhancement as some methods will change the character of the transaction and remove it from the bounds of Shariah. For example, the existence of a spread account for excess cash flows would result in the loss of pass-through status as the originator would be able to retain undistributed cash over that being paid to the investors.

With a monoline financial guarantee policy or a "wrap", the basic principle is that the obligors are not providing any additional security, rather the investors realise a reduced yield on their investments in exchange for the provision of a guarantee of their principal by a suitably rated entity. Provided the cost of the wrap is less than the reduction in yield that investors are prepared to accept by "wrapping" the transaction, this becomes an attractive option to the Issuer. Certain wraps are deemed permissible by Shariah. In the recent Islamic Development Bank (IDB) issuance, the IBD provided the equivalent of a wrap by guaranteeing the performance of the underlying assets and agreeing to repurchase the underlying asset pool at a pre-determined price on the maturity date of the Sukuk certificates. This arrangement was deemed to comply with Shariah.

5.4 SECURITISATION CASE STUDY - HANCO VEHICLE FLEET SECURITISATION

Introduction

This is the first Shariah compliant Sukuk to be issued out of Saudi Arabia. It is a SR102million (US$27.2million) securitisation of leased moveable assets (a motor fleet belonging to a car rental company, Hanco). Each Sukuk certificate has a three-year life expectancy and offers investors a 6% profit rate throughout its life. The transaction makes use of traditional credit enhancement techniques exhibiting 15.39% overcollateralisation, a 4.2% equity tranche and an 8.77% cash reserve. The structure also incorporates early warning triggers to mitigate performance risk.

Structure

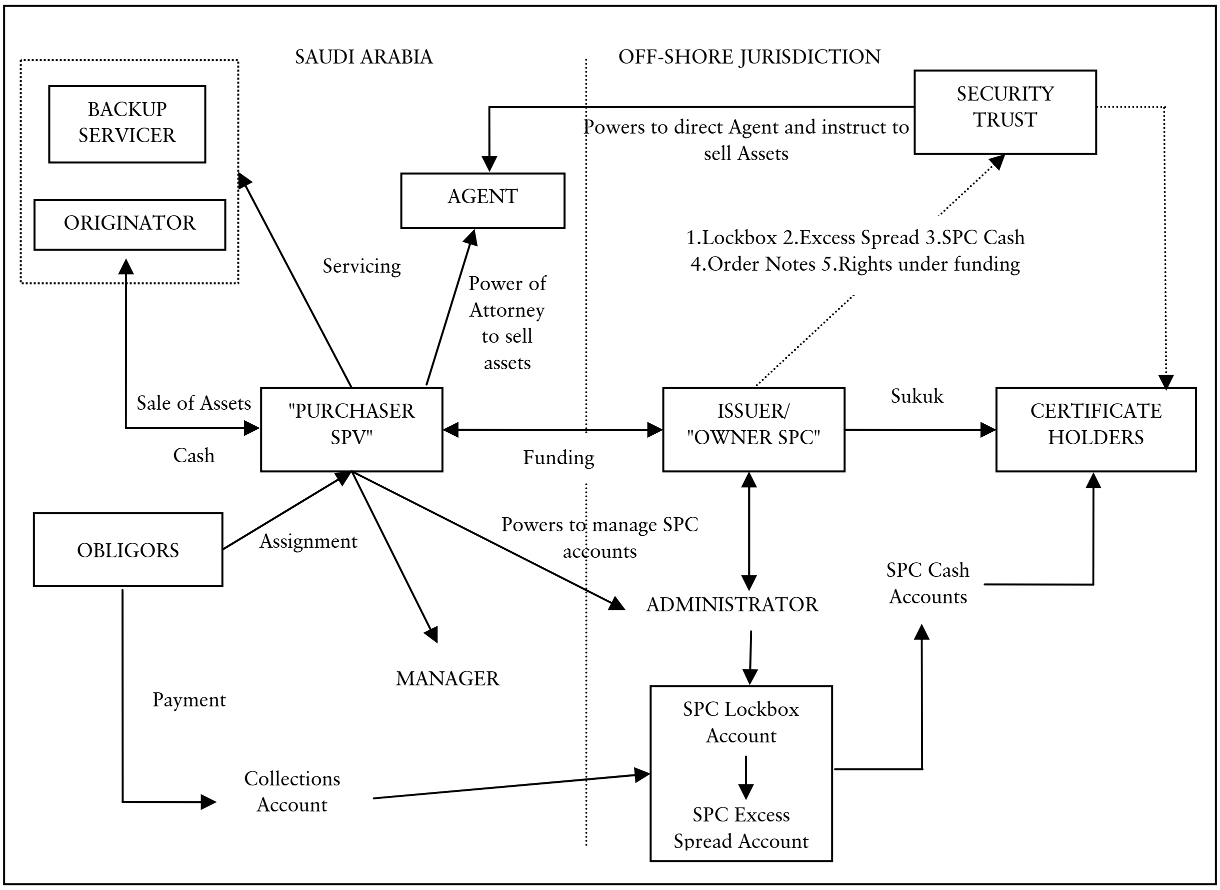
At first sight Saudi legislation appears to limit the scope of securitisation. For example, there are stringent Saudi laws which prevent foreign ownership of locally domiciled assets, meaning that in this securitisation a foreign domiciled SPV could not own the rental company's assets. To circumvent this restriction a two-tier SPV/SPC structure (see transaction diagram overleaf) was established. One SPV was incorporated in Jersey, which issued Sukuk certificates. The proceeds of this issue were passed on to a Saudi domiciled special purpose company that used the funds to purchase the assets from the originator.

In order to conform with Shariah, the funding relationship between the two special purpose vehicles could not be classified as a loan. Therefore the arrangement, unlike a loan, encompasses aspects of risk and return sharing, ring fencing and flow through and does not bear interest. Furthermore, Shariah requires that payments on the Sukuk certificates must be linked to the underlying assets, making the nature of the relationship between the two special purpose vehicles crucial. Shariah scholars advised that the Shariah compliance of the relationship could be derived by looking at the substance of the relationship rather than its form. IAS 39 and SIC 12 arguments were used to demonstrate that this relationship was more than a funding arrangement and encompassed a series of security packages. This argument provided the necessary comfort that the return on the Sukuk certificates was linked to the underlying assets.

There was no government support in this transaction and consequently the robustness of the security package was of vital importance for the investor. Saudi law prohibits the pledging of assets to companies outside Saudi Arabia and therefore the Saudi domiciled SPV owns the assets. However, all monies flowing to this vehicle are held in an off-shore bank account (*Excess Spread Account*), over which security is taken. In the event the cash flow from the underlying assets is not sufficient to meet the payment flow obligations under the transaction, amounts in the Excess Spread Account are available to meet with shortfall. Security over the assets to the extent permissible was granted to the trustee (on behalf of the holders of the Sukuk certificates) by rights under various agency and security agreements being assigned to the trustee by the Issuer.

Rating

Initially, the transaction was structured to achieve a rating which was expected to be equivalent to the sovereign rating of Saudi Arabia. However, the rating agencies were not able to achieve the necessary comfort in relation to the structure. As, Shamil Bank, Bahrain was the only purchaser of the Sukuk certificates and obtaining a rating was not a prerequisite to its purchase of the Sukuk certificates, it was not fatal that a rating was not assigned to the structure. In addition, a legal opinion was not forthcoming which explained how profit sharing would be enforceable under Shariah.
In the future, if obtaining a rating is vital, a possible solution may be to secure an offshore wrap. Attempts to do so in this transaction proved prohibitively expensive but in the future this cost may decrease as a better understanding of the concepts involved in a Shariah compliant securitisation are gained by the international community.



5.5 SECURITISATION HURDLES

Securitisation seems to be proving a useful addition to the traditional financing techniques for companies in the MENA region. However, before the market can develop with certainty, certain legal and cultural hurdles need to be overcome and some of these are outlined below.

Derivative contracts

The need for derivative contracts in conventional structures generally arises where (i) there is a mismatch between the currency of the receivables payments and the payments to the certificate holders, and (ii) where payments under certificates are linked to a floating rate of return which differs from the return generated by the assets. In practice, in certain Gulf countries point (i) above does not prove problematic as receivable payments in certain Gulf countries are generally denominated in US dollars. However, when apparent, the inherent mismatch typically requires embedding currency options, forwards or swaps within a securitisation structure.

Shariah has typically rejected derivative products as they encompass interest, uncertainty or gambling. After all, currency risk can be hedged or reduced to zero with forward contracts being simultaneously transacted. Consequently, once risk is eliminated, the gain is clearly Riba, hence a substantial modification of the risk patterns in the underlying assets which is not acceptable under Shariah.

Despite traditional prohibitions, institutions are attempting to devise derivative or similar products which are compatible with Shariah. The International Swaps and Derivatives Association (ISDA) Middle Eastern working group is currently in contact with regulators in Saudi Arabia, Kuwait, Qatar, Dubai and the United Arab Emirates in an attempt to formulate such products. The working group is expected to report its findings in the near future.

Absence of regulation

In the majority of MENA countries there is little securitisation specific legislation. This should not necessarily hamper the development of the market, after all, deals are coming to the market in jurisdictions that lacks such legislation. Imaginative structuring in some cases is a suitable substitute for such legislation. This may be seen in Lebanon for example, where a transfer of assets can be effected in accordance with article 280 of "Code of Obligations and Contracts" or in reliance on the Fiduciary Trust Law N. 520 which covers "Financial Markets Development and Fiduciary Contracts." A Lebanese SPV may be (i) a company with a variable capital regulated by the Commerce Code, (ii) a community according to "Code of Obligations and Contracts" or (iii) a fiduciary regulated by Central Bank Directive N. 6601. With any of these structures, an asset transfer may be completed on a true sale basis. Marketable securities are regulated by article 252 of Code of Commerce, and their trading on the Beirut Stock Exchange is easier since the introduction of a new section in Decree N. 7667, which encourages innovation and allows "all other securities or financial negotiable values."

Unstable Tax environment

In the absence of specific legislation, tax issues can erode the economics of a securitisation transaction. In a two-tier structure where the "Owner SPV" will have to route funds to an offshore "Issuer SPV", such funds may be subject to withholding tax. Such a charge may be circumvented by the application of certain tax treaties or establishing vehicles in certain tax "friendly" countries.

Difficulties may arise where legislation promoting securitisation is enacted but the government, either due to failing to appreciate the substance of such concepts or due to temporary governmental cash shortages (which are common in emerging markets), modifies the laws in a way to levy taxes on such vehicles. Such an alteration in tax legislation may cause the payments to certificate holders to become unworkable resulting in a default in the structure.

Tax legislation throughout the MENA region is considered by some as unstable. In Lebanon for example, there was a swing in income tax rates, VAT was introduced without lowering the customs duties and the enactment of a tax-neutral fiduciary trust law in 1996 was later subjected to double taxation in 2003. Tax stability is required for securitisation to flourish and to fuel investor confidence.

5.6 FUTURE TRANSACTIONS

Despite the need to overcome certain hurdles it seems the market shows promise of growth. At present there are large scale construction projects being undertaken throughout the United Arab Emirates. For example, in Abu Dhabi there are currently five power projects (affectionately referred to as the "Gulf Iceberg") being constructed, the largest of which has a value of US$3billion. Abu Dhabi banks may require to free up bank capital for new projects. This can be achieved by refinancing the existing loans that they have made to these developers. One such way is to look to the capital markets. If this development spur continues, the demands for efficient capital across the region are easy to identify. Consequently, if the underlying obligations are financed in accordance with Shariah, structuring a Shariah compliant securitisations of these obligations is far from a remote possibility.

It is reported that Kuwaiti and Lebanese banks are repacking their non-performing loans (in the former case, those dating prior to the Iraqi invasion) in to an SPV. This is spurred by pressure from their central banks to clear their books in response to the Basel II and the IAS 16 regime. Analysis of the nature of the underlying obligations will determine whether these can form the basis of a Shariah compliant securitisation.

6. Conclusion

It cannot be questioned that Islamic finance, in particular the Sukuk and Shariah compliant securitisation market, are growth areas. The Islamic finance industry will continue to evolve and more complex Shariah compliant products will come to the market. Investor demand will drive the industry and will ensure Islamic finance institutions and regulators work together to overcome some of the hurdles discussed in this note.