BUSINESS RECORDER
http://www.brecorder.com/section/50/40/1116205:opportunities-in-islamic-securitization.html

Opportunities in Islamic securitization

By: Asim Hameed Khan

ARTICLE (October 24, 2010) : Pakistan is the lead player in Islamic securitization! The local regulators have traditionally encouraged exploring and introducing complex asset-backed financing structures at large. Although the entire banking and non-banking financial sectors are now facing difficulties due to global financial turmoil, a sharp upturn can be seen on the heel of Islamic securitization through participation by private and corporate sectors.

Typically in conventional market, security is a document representing receivable amounts owed by the issuer in favour of the holder. Normally, the amounts secured by a security are interests bearing loans. There are different classes of securities such as bonds, issued by a company, bonds issued by a government, debentures, certificates, notes and treasury bills.

Sometimes the term "security" is applied to non-interest-bearing documents also, such as bills of exchange or shares of a company. The basic purpose of securities is to keep them as a means to facilitate liquidity whenever needed. When the holder of the security needs cash, he can sell the security to a third party in the secondary market.

'Islamic securitization' is issuance of 'certificates of ownership' against an asset, investment pool or business enterprise. Basic guidelines are also provided on the negotiability and sale of these certificates in the secondary markets. Securitization can be done under the structure of Musharakah, securitization of diminishing Musharakah, hybrid securitization, securitization of Ijarah, securitization of Salam and/ or Istisna.

Under Islamic law, securities representing a loan or debt cannot be sold or purchased in the secondary market because, if they are sold at a price higher or the lower than their face value, they involve "Riba" and if they are purchased at their face value, they involve "Gharar". However, they may be assigned to a third party at par value. The difference between sale and assignment (Hawala) is that transfer in Hawala is with recourse while transfer in sale is without recourse. If the securities represent the proportionate ownership of the holder in illiquid or tradable assets, the trade of such securities is permissible and is tantamount to sale of holder's proportionate share in the assets.

MUSHARAKAH SECURITIZATION Some people claim that the conventional bonds and Musharakah certificate appear similar. It must be understood that a bond is issued to evidence a loan and has nothing to do with the actual business undertaken with the borrowed money while the Musharakah certificate represents direct pro rata ownership of the holder in the assets of the project.

In the case of large projects where huge amounts are required which a limited number of people cannot afford to subscribe, the prescribed securitization mode of financing can be used under Musharakah. A Musharakah certificate is given to every subscriber and represents their proportionate ownership in the assets of the Musharakah, and when the project commences business by acquiring substantial non-liquid assets, these Musharakah certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. Nevertheless, trading in these certificates is not allowed when all the assets of the Musharakah are still in liquid form. Here importance must be given to the distribution of profit earned by the Musharakah which must be shared according to an agreed ratio and loss must be shared on pro rata basis.

The certificate will be sold in the market at par value until work on the project is started and it has illiquid assets. This is due to Islamic rules governing exchange of currency, where when money is exchanged for money, both counter values must be of equal amount. Any excess from either side is Riba. However, when the project contains illiquid assets like land, building, machinery, raw material, and such, the Musharakah certificates will represent the holders' proportionate ownership in the tangible assets and not in liquid assets (ie money) alone; and, it is allowed in Shar'iah to sell these certificates in the secondary market at any price.

The question arises about the rules of Shar'iah and its attitude towards tradability of shares of a project comprising of both liquid and non-liquid assets, A difference of opinions is seen between contemporary Muslim jurists. The Hanafi school is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business. Some contemporary scholars, including those of Shafai school have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%; however, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are at 20%.

SAMPLE CASE STUDY The Musharakah model can be better explained through the use of a case study: The ABC Company plans to raise funds through issuance of Musharakah Sukuk to finance expansion of its plant costing US $12 Billion. A group of Islamic Financial Institutions (IFIs) agree to finance the expansion based on profit and loss sharing at the operating profit level.

The ABC Company and IFIs sign a Musharakah agreement after which ABC issues Musharakah Term Finance Certificates (MTFCs) in return of cash proceeds from the investors. As per the Musharakah agreement, MTFC holders are entitled to a share in the operating profit of ABC; loss, if any, will be shared in the proportion of respective investment of parties. A portion of profit share is contributed to the Takaful reserve which will be paid back to the holders at the time of final settlement/redemption. To mitigate profit rate risk, a Takaful reserve is created and maintained by ABC, to which both parties agree to contribute equal amounts. ABC contributes an amount of US $1.2 billion to create Takaful reserve and maintains it during the tenor of the Sukuk. The funds will be utilised to make good any shortfall in the actual profits of ABC. In case of no loss during the Sukuk tenor, the amounts contributed to Takaful reserve will be paid back on final settlement.

At the end of MTFC tenor, ABC pays to the Musharakah Term Finance Certificate (MTFC) holders the exercise price of the plant under an irrevocable purchase undertaking to redeem the certificate. At this time the Takaful reserve is also liquidated and the balance, if any, is paid back to the original contributors.

(1) Cash proceeds, (2) Musharakah Sukuk, (3) ABC Ltd contributes an amount to create Takaful Reserve, (4). Period of profit payment, (5) Portion of profit contributing to Takaful Reserve, (6) Liquidation of Takaful Reserve at the time of redemption.

IJARAH SECURITIZATION The well-established Islamic Financing structure of Ijarah is considered acceptable by Islamic scholars. On basis of Ijarah Sukuk, a secondary market of Islamic bonds or Sukuk can be created. The owner/lessor purchases a proportion of the leased asset and as evidence; a certificate is given to the lessor which may be called 'Ijarah certificate'. This certificate will represent the holder's proportionate ownership (undivided part of the asset) in the leased asset and they will assume the rights and obligations of the owner/lessor to that extent. Each holder of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly the investors will also assume the obligations of the lessor to the extent of their ownership. Therefore, in the case of total destruction of the asset, they will suffer the loss to the extent of his ownership. These certificates can be negotiated and traded freely in the market and can serve as an instrument that is easily convertible into cash. Thus they may help in solving the problems of medium term liquidity management faced by the Islamic Financial Institutions (IFIs).

If the certificate has right to claim rental payments only and has no relation with the leased asset, such securitization will not be considered as a Shar'iah-compliant instrument. This is because rent after being due is a debt payable by the lessee and debt or any security representing debt only is not a negotiable instrument in Shar'iah. Consequently, this type of Ijarah certificates cannot serve the purpose of creating a secondary market. It is, therefore, fundamental that the Ijarah certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.

CASE STUDY To reduce government borrowing from the central bank and promote Islamic finance, the government of Pakistan had taken some good initiative and launched GoP Ijarah Sukuk that helped to generate a total PKR 42 billion (US $492 million). The government is targeting to raise further PKR 100 billion (US $1.1 billion) from Sukuk.

Under GoP Ijarah Sukuk, a special purpose company, wholly owned by the Ministry of Finance, Government of Pakistan has been formed to act for and on behalf of Sukuk holders, namely, Pakistan Domestic Sukuk Company Limited (the "SPC"). The State Bank of Pakistan ("SBP") will conduct an auction by which Sukuk Investors will be identified. Pursuant to the Certificate Subscription Undertaking, Sukuk Investors will appoint the SPC as an investment Agent. The SPC will enter into a Purchase Agreement with the Government of Pakistan or National Highway Authority (GOP) for purchase of certain pre-identified tangible assets, such as a Portion of the M3 Motorway for the first Sukuk issue (Sukuk Assets) at an agreed price (Purchase Price) equivalent to the Sukuk issue (Sukuk) amount.

Pursuant to a declaration of trust, the SPC (as trustee) will declare its responsibilities towards the Sukuk holders. The SPC (as Lessor) will enter into an Ijarah Agreement with GOP (as Lessee) wherein SPC will lease the Sukuk Assets for a fixed period, being three years in case of the first Sukuk issue. Lease Rentals will be paid on a semi-annual basis, ie a total of 6 lease rental periods for the first Sukuk issue. Lease Rental means an amount equal to the product of (i) the rental rate for such rental period, (ii) the margin, (iii) the number of days in such rental period divided by 365, and (iv) the face value of the Sukuk issue, plus the Supplementary Rental for such Rental Period.

Supplementary rental means expenses incurred by the service agent in respect of maintenance repair and insurance of the Sukuk Assets equal to the amount payable by the SPC under the Service Agency Agreement (as notified to the SPC by the Service Agent) in respect of the most recently expired lease period. Major Maintenance, Repair and Insurance responsibilities will be undertaken by the SPC (as beneficial owner of Sukuk Assets) but may be delegated to GOP as Service Agent under a Service Agency Agreement in consideration for a fee.

At maturity or upon an Event of Default, the GOP undertakes to purchase (pursuant to a Purchase undertaking) the Sukuk assets at the Exercise Price. The purchase Undertaking clearly states that the Exercise Price will be an amount equal to the initial cost of the Sukuk Assets plus any accrued amounts under the Ijarah Agreement with respect to the Supplementary Rental. Banks subscribe to their respective share of the Sukuk Issue through the Subsidiary General Ledger Account mechanism. SPC (as Issuer) will issue Sukuk Certificates, the proceeds of which it will use to purchase of the Sukuk assets. Each Sukuk certificate will represent an undivided interest in the Sukuk assets.

Alternative structures are being contemplated based upon other well-known Islamic financing methods (such as Istisna, Salam, Musawamah, and Diminishing Musharakah). The biggest challenge that Islamic Financial Institutions (IFI's) are facing is producing potential instruments that can be traded freely in the secondary market. The Ijarah Sukuk does, however, suffer from some commercial disadvantages for the issuer, namely finding an appropriate underlying asset, having the underlying asset tied up for the term of the transaction, potential stamp duty and taxation costs associated with introducing the asset into the structure and the costs associated with ongoing Shar'iah audits of the asset.

Furthermore, the Government of Pakistan plans to launch domestic Sukuk bond within the next few weeks by pledging assets of 2,200 acres land of Jinnah Terminal, Quaide-e-Azam International Airport in Karachi. The Sukuk will generate around PKR 35 billion (US $410 million) that will help cut fiscal deficit; The Sukuk will be of one, two and three year maturity.

Conclusion The Sukuk Ijarah and Musharakah are the two concepts of securitization which have been successfully used by public and private sectors. As against many conventional instruments, they are based on real assets and therefore, are more stable in turbulent times. In the coming years, they are expected to assist Islamic Financial Institutions in meeting their medium term liquidity needs.

The writer is attached with Product Development, Shar'iah Compliance & Islamic Financial Advisory Department (PDSC) Meezan Bank Limited)

asim.hameed@meezanbank.com