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The Impact of the Credit Crunch on Islamic Securitisation

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Effect of current market conditions

Perhaps the biggest innovation in the capital markets in recent years has been the growth of Islamic finance through the issue of sukuk and, more recently, Sharia compliant securitisations, mainly from issuers based in the Gulf and Malaysia. It is estimated that over US\$100 billion sukuk are currently outstanding.

Sukuk are usually described as asset-backed securities and take the form of notes or certificates that represent ownership of an underlying pool of assets. This suggests that sukuk investors should be entitled to the ongoing cashflows and proceeds of sales from those assets but in reality, in the event of an insolvency or an event of default, a purchase undertaking is usually triggered and the assets are transferred to the provider of the purchase undertaking, leaving the sukukholders with an unsecured claim against the provider of the purchase undertaking. As a result, when these issues have received a rating in the past, it has typically been the same as the corporate rating of the provider of the purchase undertaking. A Sharia compliant securitisation which reflected the economic structure of a conventional securitisation would allow investors to participate in the profits and losses generated by the assets placed in the securitisation pool rather than the creditworthiness of the originator and would therefore mitigate some of the concerns expressed by some Sharia scholars about the balance of risk and rewards enjoyed by sukuk investors.

There has been some discussion about whether the capital markets in the Middle East, supported by petrodollars, are robust enough to withstand the effects of the credit crunch which has affected the global markets generally. This seems an odd argument since a large proportion of Sharia compliant deals are placed with conventional investors outside the region, who have found them a useful way of gaining exposure to the high growth markets of the Gulf, which are otherwise difficult for international investors to access. This is borne out by the fact that, as at 31 August 2008, the number of sukuk coming to the market are substantially less than last year (US\$10 billion to date compared to issuances of US\$16 billion for 2007) and the returns being paid on the sukuk which are issued are significantly higher than twelve months ago, with investment bankers reporting that an issuer is now required to pay at least one per cent above what it would have paid last year for a similar transaction.

The effect of the credit crunch has also been exacerbated by the decline in the value of the US dollar, resulting in increasing issuances in local currencies which may be less attractive to investors outside the Gulf region. In addition, the debate triggered by Sheikh Taqi Usmani's comments in November 2007 and the AAOIFI statement issued in February 2008 that musharaka and mudaraba based sukuk should not use purchase undertakings



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with predetermined exercise prices in order to guarantee the return at the commencement of the transaction, affected a large number of sukuk and has resulted in the need for issuers to either find assets which can be used in ijara-based structures or, where such assets are not easily available, to consider alternative structures, resulting in a slow down in the growth of the industry.

Caravan I

The first Islamic securitisation deal is generally believed to be the issue by Caravan 1 which was launched in March 2004. Caravan 1 was a \$27 million Sharia-compliant sukuk, securitising a Saudi Arabian car-fleet inventory. The structure involved an SPV in Saudi Arabia funding the acquisition of a pool of vehicles and vehicle lease arrangements from Hanco Rent-A-Car, a large Saudi car leasing and rental company, via a separate Jersey-registered SPV. The dual-SPV structure was required because a local SPV would not have been bankruptcy remote, while, under Saudi commercial law, an offshore SPV is barred from buying or leasing vehicles directly. The deal was structured so that, in the event of default, investors have recourse to the underlying assets and can force the sale of the cashflow-generating assets. Caravan 1, however, failed to secure an official rating and had only a single class of notes.

Ensec

Caravan I was followed in 2005 by the Emirates National Securitization Corporation (Ensec), a Dubai-based specialist securitisation firm set up in 2004 to facilitate securitisation in the region, issuing a rated securitisation of mortgage assets originated by Tamweel and called Ensec Home Finance Pool 1. The US\$350 million issue was rated AAA by Standard & Poor's and Aaa by Moody's, with credit support apparently provided by mortgages and cash collateral. However, in reality, the deal was 104% cash collateralised with over US\$350 million in cash placed offshore as security, meaning it was really a securitisation of cash rather than of tangible assets.

Tamweel

In July 2007, Tamweel PJSC, a provider of real estate finance in the United Arab Emirates, issued the first internationally rated, tranching Islamic securitisation issue with all of the characteristics of a conventional securitisation: it has four classes of noteholders, a bankruptcy remote special-purpose vehicle incorporated in the Cayman Islands acting as the issuer of the notes, and a right of participation in assets and losses that is based on the pledged assets of the structure rather than on the credit risk of the borrower or originator. The \$220 million deal was lead-managed by Ensec. Morgan Stanley and Standard Chartered Bank acted as joint book-runners on the deal.

The most innovative feature in the structure was the achievement of tranching in a Sharia compliant manner through each noteholder, as a result of its acquisition and holding of a note, being deemed to agree that its right to receive payments under the notes is reserved and amounts that would otherwise be payable to such noteholder on a *pari passu* basis could be used to make payments to another (more senior) class of noteholder in priority to

it. This mechanism ensured that both losses and profits could be shared (by mutual agreement) between the different investor classes in a way that is consistent with a conventional securitisation.

The underlying portfolio comprises 829 Islamic mortgages on apartments and villas from Dubai's various free zones, the areas in which non-UAE residents are allowed to buy freehold property. The transaction is rated by Fitch and Moody's and consists of four classes of notes - under Moody's classification, Aa2, Baa1 and Ba3 tranches, plus a non-rated equity tranche. It is the first global Islamic RMBS deal to be rated investment grade. Fitch gave the senior notes an AA rating.

The transaction uses a dual SPV structure, whereby Tamweel passes the legal title and assigns the lease rentals and all the associated rights and receivables on the properties to an SPV incorporated in the Dubai International Financial Centre. The rights and lease rental receivables are then assigned to a separate, Cayman Islands-registered, SPV. This means that the contractual terms of the structure are not affected by local laws, while overcoming any legal risk associated with the recognition of true-sale under Islamic law.

Sorouh Real Estate

Tamweel came to the market just before the credit crunch really took hold last summer. It was expected that it would herald the arrival of many further Sharia-compliant, multi-tranche RMBS and commercial mortgage-backed securitisation (CMBS) deals. In fact, thanks to global concerns about the securitisation market since the closing of Tamweel, the only Sharia compliant securitisation deal that has entered the market from the Gulf region is the Sorouh Real Estate AED 4 billion (US\$1.1 billion) issue, using a mudaraba structure and achieving tranching through a masawama agreement. The three tranches issued by the Jersey based SPV, Sun Finance Limited, are rated by Moody's (Aa3, A3 and Baa3) and by Standard & Poor's (A, BBB+, BBB-).

The transaction uses a mudaraba structure where the Issuer is the investor (Raab ul Maal) and the PropCo (as defined below) is the asset manager (Mudareb). Capital is invested in accordance with a Restricted Mudaraba Agreement (investment plan) to purchase the Assets (as defined below). The Raab ul Maal has a security interest over all the assets of the Mudareb in the case of an event of default. Income from the assets is distributed as profit to the Raab ul Maal (and then onto the investors) with separate amounts being used to pay the monthly profit due and to repurchase a share of the Raab ul Maal's interest in the assets in order to achieve amortisation of the principal.

The transaction is an Islamic securitisation of the land and associated rights to payment (Assets) from a pool of GCC obligors. The 62 obligors (Obligors) are primarily GCC real estate developers who pay in scheduled instalments to purchase undeveloped land, concentrated within two real estate developments - Shams and Saraya (Developments) in Abu Dhabi (rated Aa2). The purchase contracts were originated by Sorouh Real Estate PJSC (Sorouh), one of the three key real estate developers in Abu Dhabi who have been granted land on preferential terms by the government.



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The transaction involves a dual SPV structure whereby Sorouh will transfer the land and assign the Plot Sale and Purchase Agreements (PSPAs) instalments and all the associated rights under the contracts to Sorouh Abu Dhabi Real Estate LLC (PropCo), a company incorporated in Abu Dhabi, so as to isolate the Assets from Sorouh. The Issuer will extend an inter-company loan to PropCo; PropCo will create security interests over all of its assets in favour of the local Security Trustee acting on behalf of the Issuer. There will be a transfer of the land to PropCo and registration of the title. This registered transfer, as well as the assignment of the PSPA rights, is governed by local Abu Dhabi law, while the remaining security documents are governed by English law.

the future

The future of Islamic securitisations cannot be separated from developments in the securitisation market generally, despite the demand for funding for infrastructure projects in the Gulf and the impressive increases in property prices in the region. It is hoped that the market will recover by the middle of next year and a number of potential issuers are currently warehousing their assets in the expectation that they will be able to securitise in 2009. There is certainly a huge potential for both conventional and Sharia compliant RMBS and CMBS deals in the region. Similarly, the Gulf should also be a natural home for future flow transactions and there will certainly be a demand to securitise the assets emerging from the growing retail credit market. All we need now are the investors...