Securitisation[1] and Currency Hedging under Islamic Shafi Law, Part Two

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Abstract

In the light of the increasing quantity of funds being raised in the London capital markets and elsewhere in the form of securitised Islamic bond issues, this article considers a range of key factors. What is a securitised bond and what types of Islamic financial arrangement can be used to provide the income stream to provide the repayment and return on such a bond? What is the difference between a traditional asset backed securitisation and an Islamic one, what is the difference between the structures used and how does this affect the issue? Other key elements are: the choice of law and jurisdiction utilised, pricing models, the extent to which a secondary market can function for such bonds, credit enhancement and whether it is possible to develop an Islamic securitisation utilizing derivatives to facilitate hedging any currency risk between the originator's income and the currency of the bond issue.

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Asset backed or asset based?

If one of the methods discussed in part one of this article is used as part of a securitisation structure there results an argument as to whether such an arrangement should be an asset backed on asset based structure[4]. The asset in the context of a traditional securitisation will be the income transferred from the originator to the SPV. If it can be structured on this basis then an Islamic securitisation can function in all other aspects as a non-Islamic one. However, if ownership of the underlying asset must be transferred then it would no longer be a traditional asset backed securitization[5]. In either case it is vital that there is insulation between the originator and the SPV for insolvency purposes. If not, then the advantages potentially available for a higher credit rating for the SPV and its sukuk issue than the originator disappears. Thus, if the securitisation is asset based the rating of the originator and its future income become affected by exposure to those underlying risks. The AAOIFI's view is that sukuk certificates must give "…a common title to shares and rights in tangible assets, usufructs and services or equity of a given project of a specified investment activity." [6]. They also[7] permit allowing the repurchase of assets at market price or at an agreed price at the time of repurchase. Such arrangements are also utilized by the ISDA/ IIFM Master Agreement which is discussed below. The history of such

[4] See for example the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) 2008 pronouncement that Islamic securitisation can be asset backed and the Islamic Financial Services Board's edict that it should not be, (Standard 7, 2009). For a useful discussion see Manjou FA "The Ping-Pong of the Asset-Backed/ Asset-Based Sukuk Debate and the Way Forward." In Kamal MH and Abdullah AK ibid.

[5] In the UK this requires rending the transfer immune to a claim by any future liquidator of the Originator under any of sections 178(1), 186(1), 238, 239 or 423 Insolvency Act 1986 or the equivalent if it is another jurisdiction.

[6] See for example Moody's credit rating of First Gulf Bank. Moody's Investors Services.

[7] At AAOIFI Standard 12

arrangements is quite short with the first being issued in 1990 by Shell MDS and total issues now exceed US$ 100 billion[8].

Asset types

As explained, the assets financing the sukuk issue must be shariah complaint. This has led to a degree of inventiveness in parts of the market place to maximize those available. This can be done by blending assets, some of which can be non-compliant by the use of non-physical (non-cash) assets[9] for up to 70% of the finance[10]. These ‘asset light’ and blended structures have been banned by the AAOIFI[11] but still seem evident in the market place. The key factor arising is the percentage a particular Islamic school will permit. The Malaysian Government have sought to resolve any problems by developing the structure further as the following example of a sukuk issue they created shows[12].

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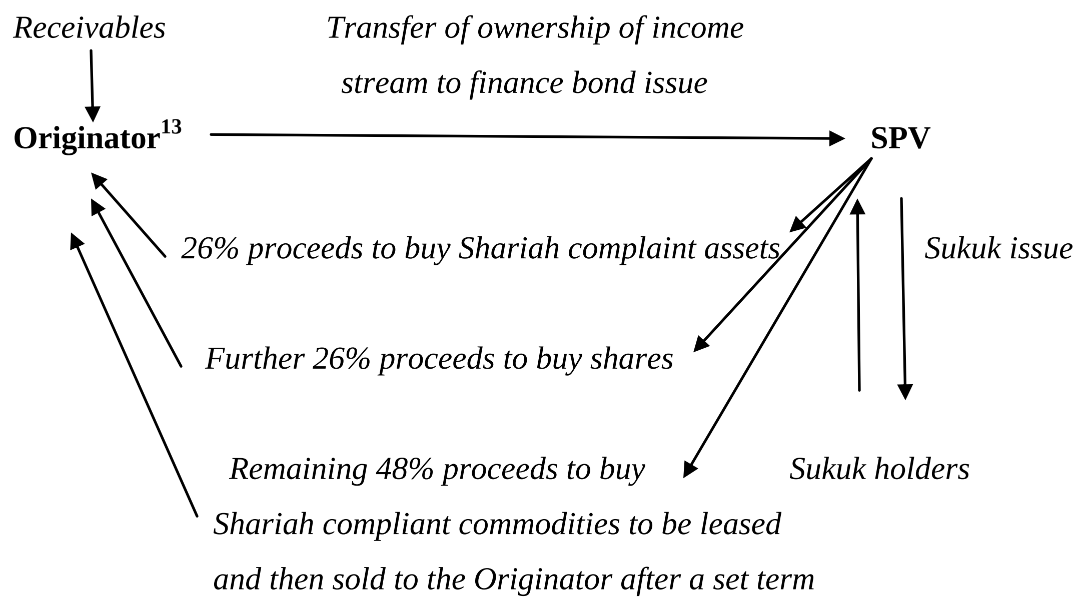
[8] Minas Q “Proposals for sukuk market brighter” Saudi Gazette, 24th December 2010
[9] Known as wakālah sukuk
[10] Haneef R “The case for Receivables-Based Sukuk: A Conveyancce between the Malaysian and the Global Shariah Standards or Buy al-Dayn?” Kamail MH and Abdullah AK *ibid* p 144
[11] AAOIFI “Shariah Board Ruling of February 2008”
[12] Haneef *Supra* p145-6

FIGURE 3



Thus an adapted securitisation structure can be used to satisfy the requirements of Islamic Shafi law.

Types of sukuk

Today Islamic sukuk have similar characteristics to conventional asset backed securities issued by a SPV under a securitisation transaction. Akin to 'pass through' certificates, the sukuk represent an ownership interest in the underlying asset(s) or its usufruct. More elaborately, they are[14]: "[c]ertificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned,

[13] In this case the Government of Malaysia
[14] Shari'ah Standard No. (18), "Investment Sukuk", published by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in November 2002 (the "Standard").

common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity."

They are generally categorised as either asset-backed sukuk, which offer fairly predictable returns to their holders based on the underlying asset; or asset based bonds, which offers less predictable returns due to the profit and loss sharing in the underlying investment[15]. They fall into their respective category based on the type of agreement that is used to structure the sukuk.

Notwithstanding the similarities many Islamic sukuk differ from conventional asset backed securities in two respects. Firstly, they are not viewed as contractual debt obligations of an issuer obliged to pay holders interest and principal on specified dates, rather they are claims to an undivided beneficial ownership in the underlying assets. Thus, the sukuk holders are entitled to share in the cashflow generated by the underlying assets in addition to being entitled to share in the proceeds of the realisation of the underlying assets. The second disparity is that not all sukuk are tradeable on the secondary market. This is discussed below.

Also, the issuing of sukuk as part of the securitisation structure raises other Islamic law issues. Asset backed securities are permissible under Shariah law provided they represent claims against individual assets and securitisations normally represent a claim against individual assets which have been pooled which should be acceptable. In

[15] Islamic Financial Services Board, Exposure Draft No. 2, Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services (2005), at page 52.

addition, bonds are normally issued at a rate of interest whilst on a shariah issue the sukuk will need to be performance linked. An Islamic securitisation structure can be used under which the holders possess an "undisclosed beneficial ownership in the underlying assets and a share in the revenues generated by the sukuk as well as a share in the proceeds upon realization."[16] Usami defines them as:[17] "…certificates issued in the name of the owner or bearer in order to establish the claim of the certificate owner over the financial rights and obligations represented by the certificate. Sukuk represents a common share in the ownership of the assets made available for investment, whether these are non monetary assets, usufructs, services or a mixture of al these plus intangible rights, debts and monetary assets. These sukuk do not represent a debt owed to the issuer by the certificate holder."

It should be added that some of the critical scholars[18] regard this as essentially un Islamic because the issues often base themselves on common interest rates, e.g., LIBOR. Certainly such sukuk have in some cases defaulted precisely because they were structured as debt instruments[19]. Islamic sukuk are structured in many ways depending on how the parties' relationship with each other is structured, and the nature and intended ownership of the underlying assets.

Choice of Law and Jurisdiction

[16] Lahlou, Tanega, *supra*
[17] Usami M.I. "Fixed Income Securities, Shari'a Perspective." [2006] p4, www.sbp.org.uk
[18] Anjum S "Islamic Finance: Structuring of Shariah Compliant Securitisation for a Global Market"
[19] Kamali M H and Abdullah A K. "Islamic Finance: Issues in Sukuk." The Islamic Foundation p 2

Islamic sukuk are often traded in major financial centres such as London, but the assets that are used to finance the issues are usually in an Islamic state. That being the case there is a potential jurisdictional matter with the key issue being the location of the originator and the assets which have been assigned, which may not be in the same place. Even if the sukuk have been issued subject to English law and English jurisdiction[20], any dispute arising over payment arising on the insolvency of the originator is likely to end up being heard in the court in which the originator was incorporated. Thus, the issue will arise of having to satisfy that state's law if the issue is to be held valid and the "true sale" held to be valid[21].

Pricing models

Another problem relates to pricing. When pricing models are created a key element will be the short term – long term interest rate spread. Under shariah law of course interest rates are not permissible. Putting a notional 'interest rate' in for purely pricing model purposes would need to include an allowance for the lack of secondary market, which would presumably widen the spread. One suggestion[22] that has been made is for institutions in this position is to work out an appropriate 'rate' by looking at recent private sukuk arrangements entered into by Islamic banks to companies with the same credit rating over a short and longer term. This will provide information as to the market value of the spread. However, such information will be slightly 'rule of thumb'. The

[20] See ISDA/ IIFA Master Agreement Schedule
[21] Kamadi MH and Abdullak AK ibid
[22] Vogel and Hayes, *ibid*

normal approach with pricing modeling is to apply a specific formula, namely that the return on capital is as follows where:

R_j is a return on a risk free investment

B^1 …..B^h describe the sensitivity of the asset's return to each of a list of factors, and

$E(R_{\text{factor }1})\ldots E(R_{\text{factor }k})$ are the expected rate of return on each of a number of factors.

$$E(R1) = R1 + B^1_i\,[E(R_{\text{factor }1}) - R_j] + \ldots + B^h_i\,[E(R_{\text{factor }k}) - R_j]$$

To calibrate this it is necessary to discern the relevant factors. There are generally seen[23] as being four key ones: industrial activity, inflation, short term – long term rate of return spread and low risk – high risk corporate bond spread.

In an Islamic economy these are no more difficult to determine than they would be in a non Islamic economy. The relevant government's gross domestic product will cover the first, inflation is normally dealt with in annual monthly government figures, but the third becomes more interesting. All other factors being equal; the greater the spread between short term and long term rates, the higher the return will need to be. The fourth of these relates to the rate of return across different periods of time, not across different levels of credit risk amongst the borrowers. As discussed above, this is not permitted by shariah law. In practice though, the fact that some firms are less attractive as a credit risk

[23] see for example Rosss S, Westerfield R and Jaffe J in "Corporate Finance" Richard D Irwin Inc, Chicago, 1996, Ch 11

does tend to be reflected in the rates of profit that are shared with investors. This, in turn gets reflected in the notional term rate figures.

Another problem that could arise in this context is that which precipitated the collapse of Northern Rock Bank in the UK; namely the drying up of the securitised bond market which in that instance partly resulted from the crisis in the U.S. sub prime market. For an Islamic bank this type of potential risk is greater because of the lack of an active secondary market in the sukuk, which in turn will make those purchasing the sukuk more cautious about the assets behind the loan. This will be accentuated if it is an asset based securitisation as the lenders' exposure to the assets behind the originator is much more obvious. Purchasers are therefore going to be limited to those willing to hold them to maturity, and this in turn will shorten the range of periods over which the bonds can be issued. This leads to an increase in the number of sequential bond issues that will have to be made to cover medium and long term loans made by the bank and as a result the issuer becomes exposed to the long term risk of the market into which the SPV must make recurrent sukuk issues.

Secondary bond markets

Illiquidity however remains a key problem with Islamic sukuk as there is no effective second hand market. This is because a sukuk that represents a debt to the holder cannot be traded under shariah law, for a debt cannot normally be traded for amount other than its face value. Rather the holder is often effectively obligated to hold the sukuk until maturity or sell them at par, which is not always practical. This is a corollary of the fact that shariah law only permits the holding of sukuk that reflect a direct interest in an underlying asset and that a debt can normally only be sold on at its full value. That said, the latter point would not be an issue for many of those buying sukuk in a jurisdiction that does not apply Islamic law such as England and Wales. Unlike shares, which some Islamic scholars accept as undivided ownership of a company's real assets, sukuk tend to reflect a generic interest in underlying assets. Some Islamic scholars[24] are adopting a constructive approach regarding this issue, but for the time being a significant secondary market does not exist in the way it does for western style corporate bonds. There are however steps being taken to develop the second hand market. To the extent that there is a secondary market it tends to operate largely at country and regional levels because of the lack of cross border infrastructure that would facilitate trading[25]. At present liquidity platforms are being created, eg, in Bahrain, but the problem remains and fears of a lack of capacity to sell sukuk in the secondary market inevitably depresses the price at which the sukuk issue can be launched. To be tradeable there needs to be the capacity to transfer ownership of the right to the underlying asset or the proceeds thereof. Sukuk satisfying the AAOFII definition[26] ought to be able to achieve this. It requires that the "…manager issuing sukuk must certify the transfer of ownership of such assets…and not keep them as his own assets."

[24] Dato N.Z. and Zaky Y. "An Islamic Perspective of Stock Markets - an Introduction" ed Abod S.G. 1992 and Mannan M.A. "Understanding Islamic Finance: A Study of the Securities Market in an Islamic Framework", Jedda, Islamic Development Bank, 1988.
[25] Shah NS. The Financial Ambassador of the Malaysian International Islamic Financial Centre. Speech, Kuala Lumpur, 12th November 2013
[26] 2008, Standard 17, Arts (2)1 and (5/1/2)2

As mentioned, sukuk can normally only be traded on a secondary market at par value. At this price in normal market conditions there would be no economic incentive for anyone to buy. However, there is an exception where the sukuk issue is financed by physical assets. As such assets can be sold as a discount so can any sukuk that represent them.

There was a particular problem a few year ago when the US $ declined in value and some of the Arab States decoupled their exchange rate from the US$, and as shariah sukuk issues were often denominated in US $ there was a consequential currency risk for the sukuk holders. The normal hedging arrangements that non Islamic bodies use to hedge currency risk: (futures, options and contracts for differences), are not normally available to them. So, in Islamic securitised sukuk issues the sukuk has to be denominated in the same currency as the originator's or either the originator or bond holder would have to carry a currency risk. In many cases both would end up doing so as the originator of an Islamic securitisation will not normally be earning its income in US$ and the sukuk holder is risking a decline in the value of the originator's currency which would reduce the value of any assets used by the originator to back the sukuk issue. This would be a particular problem in the event of the originator's insolvency with an asset based securitisation. At a time of currency unpredictability it is insufficient to hedge in a currency that is pegged to the currency concerned as the peg may be broken. With a possible rise in US interest rates being on the horizon this risk may well reverse itself. In any event there is a method of hedging currency risk that is acceptable to Islamic Shafi law and this is discussed below.

Thus, securitisation provides a safer investment than a traditional sukuk in the event of solvency problems[27]. To quote Ghani[28] “People have to remember that most sukuk are unsecured investment instruments….Those assets are there to facilitate a financial obligation of the issuers. They are not there to provide security to the investors”. However, the point with traditional securitisation is in the event of non-payment the bondholders would be looking to the assets that had been transferred to the SPV to provide the payment.

Credit Enhancement

As Islamic law does not allow contracts which involve excessive risk, issues can arise with regard to credit enhancement arrangements which most commonly takes the form of over collateralization in the calculation of the debt to be transferred to the SPV relative to the sum raised by the bond issue. It can also take the form of risk participation where a surety is paid a fee in return for an undertaking to cover any shortfall if the income being underwritten does not materialize or does not do so in full.

It has also been suggested that the requirement that the seller should have possession at the time the contract for sale is entered into can be settled by reference to prevailing custom. It has been argued that in a modern capital market that this can be

[27] Kamali M H and Abdullah A K. “Islamic Finance: Issues in Sukuk.” The Islamic Foundation p 5
[28] Ghani BA in Ferry J “Scuppered by Sukuk” 17 February 2010

satisfied by actual or constructive possession[29]. Some Islamic schools adopt a more liberal approach and thus the Shariah Board will have the last word on whether a particular credit enhancement arrangement is permissible[30]. This leaves over collateralisation as the safest arrangement to satisfy this requirement. Thus, the originator will provide more than 100% of the amount anticipated as the sum required to service the costs of the sukuk issue, interest payments and repayment. Other steps that have been taken to make the potential sukuk purchasers feel secure are for the originator to agree to maintain gearing ratios, to maintain a stated debt service coverage ratio and not to declare a dividend in a year when the debt service coverage ratio falls below a certain figure. This all tends to assist with the credit rating given to the sukuk issue.

It is sometimes the case that a double special purpose vehicle will be adopted in cases where over collateralisation is being used to assist in obtaining a good credit rating. In such cases the initial transfer of the receivables will be from the originator to SPV 1. This will be a true sale for the purposes of insolvency risk[31]. The receivables are then transferred to SPV 2 on a true sale basis for the accounting rules. SPV 2 will then issue the bonds. When the arrangement is eventually terminated SPV 2 will re-transfer any outstanding receivables to SPV 1 which can then be hived up into the Originator[32]. The reason for doing this may be that there is a dichotomy between the time when the assets will be received by the SPV and the later date at which the sukuk will be issued. SPV 1

[29] Sharia'h Standards AAOIFI, 2003. Chapter 1. For a general discussion see Uberoi P and Khadem AR "Islamic Derivatives: Past, Present and Future" in Hassan MK and Malknecht M "Islamic Capital Markets" Wiley, Chichester, 2011, p149

[30] This does not just invoke signing off the original documentation but also an ongoing review of the documentation and contracts and their implementation. AAOIFI Shariah Standard No 17.

[31] see FRS 5

[32] see Schwartz *ibid*

can be used as a ‘warehouse’ for the income being transferred from the originator in the interim. Where there is no such delay, the same structure may be used where the originator is seeking to dispose of the assets and sell them to a third party via a securitisation. An SPV subsidiary may be established to purchase and on sell the assets to a securitisation vehicle. This could be used to restructure the form of the assets either to make them marketable to certain types of fund or to restructure the assets into a form that can be on sold to Islamic buyers. A second SPV could also be necessitated because of regulatory necessity in having either the originator, a sponsor or a lender holding a specified legal interest[33]. This structure has not apparently arisen yet in Islamic securitisations, but there would not appear to be any legal barrier from them doing so.

Currency hedging under Shariah law

In some instances it may be difficult to get a securitisation structure to operate effectively because the sukuk need to be issued in a currency other than the currency used in the originator’s income stream. To resolve this problem some securitisations have utilised contracts for differences between the originator and the SPV. The reason for this is that the proceeds of the sukuk issue are in a different currency than the income of the originator and it does not wish to leave the currency risk unhedged. Matters are further complicated by the fact that most of the Islamic states where sukuk issues may be made from are not ones which have attractive currencies which foreign investors may be attracted to holding. In the case of securitised sukuk issues the originator’s income will be in that currency which will impact on the credit rating of the final issue.

[33] Rhodes N, Allen & Overy. Conversation, 22nd February 2016

Islamic law debars the sale of anything not already in existence. However, there is some flexibility on this point. Some Islamic jurists suggest that it is possible to sell an item that is not yet owned by the seller as long as it is in existence. The logic supporting such an arrangement that is acceptable under Islamic law is that what is being sold is the promise to sell. The sale item is simply the object of this. The arrangement is thus the "sale of a debt for specific consideration".[34]

The process used here is that an Islamic form of a contract for differences is used between the SPV's bankers and the issuer. In this instance a contract is signed whereby the SPV arranges with a bank to enter into a contract for differences whereby the net difference between the proceeds of the sukuk sales in one currency are 'swapped' against an agreed sum in the currency which the originator wishes to acquire. At the date of repayment of the bonds the contract for differences will re-swap the relevant amounts. Clearly this will involve the SPV in costs to finance the arrangement and the originator will need to factor this cost in from the outset. This can also be an advantage if the jurisdiction in which the relevant parties are located would impose stamp duty on a transfer of the funds. Contracts for differences are normally immune from this. Thus:

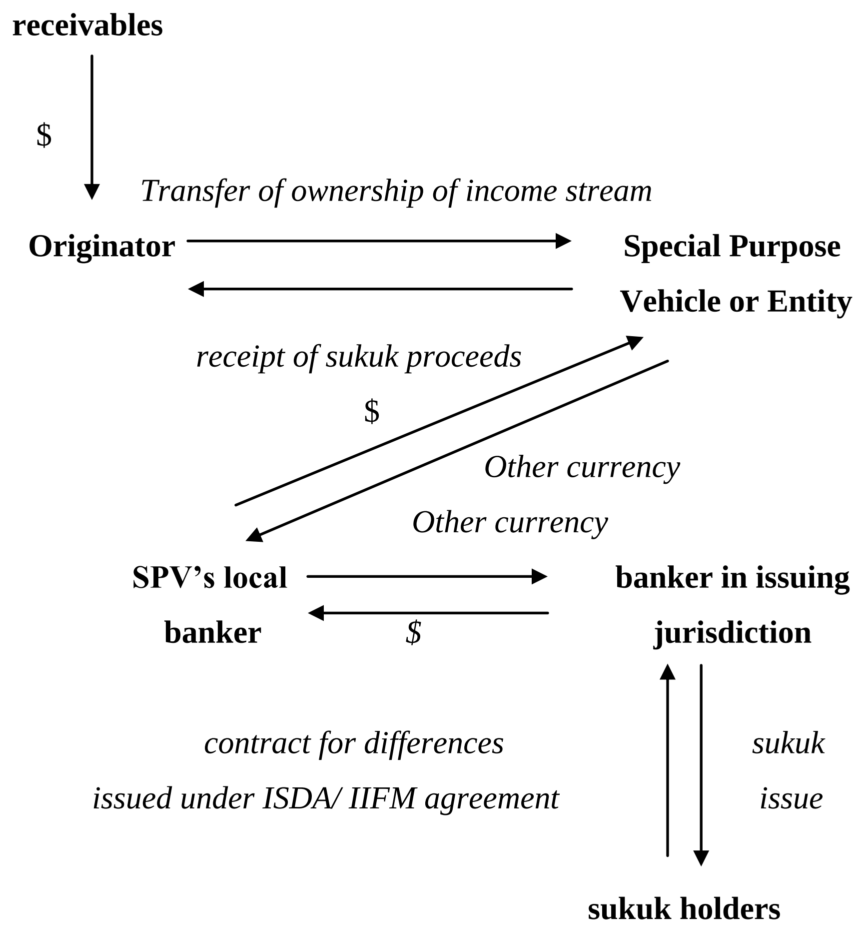
FIGURE 4

Securitisation utilising a contract for differences to hedge currency risk[35]

pool of

[34] Brunschvig R "Corps certain et chose de genre dans l'obligation en droit musukman" in Etudes d'Islamologie. Maisonneve et Larose, Paris, 1976 vol II p 305-6

[35] Haynes A "The Law Relating to International Banking." Bloomsbury Professional. 2010 p 217



This is a problem in Islamic securitisation as derivative contracts such as contracts for differences are not traditionally permitted. The bases of this objection are that the arrangement amounts to a type of gaming, that in may in some cases be uncertain in financial outcome and it may also allow one party to buy or sell, even if notionally, an asset that does not exist at the time of the contract[36]. However, it may be possible in Shafi Islamic jurisdictions to create an equivalent state of affairs. In this context what is required is a cross currency swap. This is in essence a contract where party A borrows in one currency, usually because they can access the currency cheaply due to being based in that jurisdiction and party B does likewise in its jurisdiction. The parties can then 'swap'

[36] Burhaniddin Abi'l-Hasan al-Marghinani "Kitab al-Hidaya" Vol XVI

their respective currency positions and each then access the foreign currency at a lower rate than they could have accessed it directly[37]. In practice this usually now consists of a bank creating such an arrangement and borrowing one of the currencies themselves. They will then enter into a deal with a counterparty and the netted off difference between the two currency sums will be settled periodically during the period of the contract[38]. In practice the SPV's local bank and the banker in the jurisdiction from which the sukuk are issued (which may be the same one) will adopt a version of this covered by the ISDA/ IIFM Master Agreement which satisfies the Shafi school of Islamic law. As the two sums have the same value at the outset that part of the arrangement should not present problems under Islamic law. The second stage is the key problem. The future interest rates, or at least the equivalent sum in lieu of interest, would potentially fail the certainty test.

The ISDA/IIFM[39] Master Agreement helps resolve this problem for the purposes of hedging[40], which in this context requires a tangible transaction[41]. The Master Agreement is an overall [42]agreement under which a succession of contracts are entered into between two parties. A main benefit of this is that all the contracts can potentially be

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[37] Hudson A. "The Law on Financial Derivatives". Thomson: Sweet & Maxwell, London. 2006, p47. See also Price JAM and Henderson SK "Currency and Inerest Rate Swaps". Butterworths, London. 1998, p 16 - 18

[38] Haynes A, The Law Relating to International Banking. London, 2010, p47

[39] International Securities and Derivatives Association and the International Islamic Financial Market produced both the Tahawwut Master Agreement and the two templates for Islamic profit rate swaps in 2010.

[40] ISDA/IIFM Taharwwt Master Agreement (2010) for Islamic Cross Currency Swaps (Himaayah MinTaqallub As'aar Assarf) Explanatory Memorandum, section 2

[41] Uberoi P and Khaten AR "Islamic Derivatives, Past, Present and Future" p 155 in Hassan MK and Mahlknecht M "Islamic Capital Markets" Wiley and Sons, Chichester 2011

[42] ISDA/ IIFM Template DFT Terms at Paragraph 10

netted off[43] against each other in the event of one party becoming insolvent, thus greatly reducing the amount of capital each party is putting at risk. As in the interim only the net balance is ever at risk this hugely increases the amount of capital the counterparties can risk tying up in such contracts. However, due to the requirements of Islamic law two agreements rather than one are needed. This consists of an undertaking[44] made by the buyer of the asset (in this case a currency) to the other that they will fulfill their part of the arrangement and buy at the agreed price, or the formula by which the price will be calculated. A murabaha Asset Sale Confirmation must be signed at the time of sale. An equivalent contractual arrangement is entered into by the seller. This arrangement will cover the initial exchange of currency A for currency B at the start of the contract and the final re-exchange at the end. In the case of the ISDA/ IIFA Master Agreement, the counterparties will each complete a template under which each party separately undertakes to transfer assets (in this case currency) of a particular value to the other and received an agreed price (or a formula to calculate the price) plus a profit or loss in return. At termination of the contract the assets will be transferred back by both parties.

The originator could thus issue certificates representing the ownership of assets creating the relevant future income. The SPV could issue certificates representing the sum of money raised from the bond proceeds. These could be notionally ‘swapped’ as the bond certificates could be traded for a certificate representing ownership and any necessary balancing payment could then be made between the parties to make sure the arrangement represented equal values being traded. A key issue would be whether there

[43] Shea A. “The usefulness of netting agreements in international banking.” JIBL [1991] p 132 - 138
[44] The Arabic term *wa’ad* is used in the ISDA/ IIFA Master Agreement

was a passing of ownership and risk which is a pre-requisite to most Islamic schools accepting the arrangement. It would also be dependant on the sukuk holders effectively acquiring an interest in the assets held by the Originator which provide the relevant income. The success or failure of the arrangement would thus depend on the wording of the relevant master agreement.

Conclusions

As seen, problems arise because in many jurisdictions there are disparate interpretations of how Islamic law should operate. This leaves a securitisation created subject to Islamic law open to interpretation if a jurisdiction in which it comes before a court does not take the same view as those who drafted the arrangement in another. In part this is a consequence of different standards of interpretation of the Islamic religion rather than just how it should be applied to finance law. In part also it is a consequence of the fact that Islamic jurisprudence is also partly based on the lex juris[45], the international private law developed by legal practitioners in this area. This also differs from region to region as a consequence of different religious approaches. In practice this problem is normally got round by making sure the choice of law and jurisdiction clause in the relevant certificates is made subject to the law of a state where the Islamic Board of Banking Supervision have approved the precise nature of the arrangement being utilised.

[45] T. Frankel "Securitization, Structured Financing, Financial Asset Pools and Asset-Backed Securities." (1991) at p3. See also J.H. Dalhuisen "Legal Orders and their Manifestation: The Operation of the International Commercial and Financial Legal Order and its Lex Mercatoria." (2006) 24 Berkley Journal of International Law p 129.

Secondly, there are Islamic theologians who regard much of the attempt to construct Islamic securitisations, and indeed other western based financial structures such as derivatives, as an artificial manipulation of legal form[46]. This is an argument, that so far as modern financial instruments are concerned seems to have been running since the 1970's[47]. As far as this approach is concerned, those taking a stricter line believe that the substance of Islamic law is being subverted by a need to satisfy artificial legal forms that developed in western law. For example Hamoudi sees constructing western style financial structures as "legalistic abstractions" which are the same as "…their forbidden counterparts, albeit with semantic alterations….associated with creating the appearance of difference."[48] He sees the whole approach as sophistry, designed to circumvent the provisions of Islamic law. Usmani[49] regards it as a "legal trick" and sees it as avoiding the Islamic economic order. He[50] goes as far as claiming that 85% of sukuk are not shariah compliant. In other words, the very acceptance of western financial and legal forms by adapting terminology and dressing the concepts up cannot by its very nature satisfy Islamic law. More traditionalistic jurisdictions may therefore not develop a securitisation market at all. The constructionists on the other hand see the critical school as having no methodology for dealing with many finance law issues. The critical issue in any securitised sukuk issue will be the view of the Islamic board of banking supervision in the state of issue of the bonds.

[46] *ibid*
[47] E.g., Council of Ideology (1986) "Consolidated Recommendations on the Islamic Economic System."
[48] see also Lahlou M.S. and Tanega J "Islamic Securitisation Part 1 – Accomodating the Disingenuous Narrative. JIBL [2007] No 6 p300
[49] Usmani MT, "Verdicts on At-Tawarruq and its Banking Applications". Research paper, International Shari'ah Research Academy for Islamic Finance. www.kantakji.com/media/7245/a-68-.pdf
[50] Usami ST "Sukuk and their Contemporary Applications" paper to AAOIFI, 2009

This may be one reason for the failure of a significant secondary market to develop in Islamic financial sukuk through a reduction in the number of potential buyers for religious reasons. Exacerbating it is the failure of the relevant accountancy regulators to develop a precise methodology for determining exactly what an investor has purchased as an interest where such investments are concerned[51]. Coupled with this lack of liquidity in the market is also the existence of complicated transactional arrangements and the fact that relevant risk management strategies are still developing. In the past this has not stopped a market developing but until the last two years it has been a market dominated by sovereign issuers where the purchasers of the bonds are motivated by the credit rating of the originator rather than that of the bond issue itself[52].

However, there are signs that all these problems are being overcome in practice and that Islamic finance in general and Islamic securitisation in addition will continue to develop as a significant element in the world of international finance. According to Suleiman Abdi Dualeh[53]: “Islamic institutions…have…permitted a philosophy in financing based on direct asset financing, rather than lending funds to entities and individuals. They have all along suffered from having to deal with financial intermediaries whose interest rate products are not Islamically acceptable. Securitisation enables Islamic institutions to by pass those shortcomings by engaging themselves directly with the assets to be financed and with the investors in pools of these assets. It

[51] Vogel F.E. and Hayes III S.L. *supra* p.13
[52] Hales A , *supra*
[53] Abdi Dualeh, S “Islamic Securitisation: Practical Aspects”, Conference paper, Hilton, Geneva, July 9th 2008. World Conference on Islamic Banking

also enables Islamic institutions to regulate the Islamic acceptability of the terms under which the users hold these assets."

The further development of this market is also affected by the absence of governmental organisations facilitating the development of the market. For example, the U.S.'s creation of FNMA[54], FHLMC[55] and GNMA[56] [57] greatly facilitated the development of the securitisation market for bonds issued against the income from residential mortgages. This occurred both in the immediate sense of the bond issues having a ready market due to the fact that there was effective state backing for the bond issues (albeit at the time of the development of the market an implicit one in the case of the first two) and also the fact that the scale of development led to the standardisation of legal documentation, thus further facilitating the development of the market. There is, as yet, no equivalent structure to enhance the shariah securitisation market. Likewise, although regulators are recognising shariah sukuk issues there is not the clear cut recognition in every state as to where such sukuk issues fit into the regulatory structure, although this is starting to change.

Creating a shariah structure requires that the scheme be certified by a recognised shariah scholar and there is a shortage of them in some parts of the world, though this is less of a problem than it used to be. This tends to slow down the creation of more schemes. Legal opinions from such states may not always be available from large,

[54] Federal Home Loan Mortgage Corporation, established in 1938
[55] Federal National Mortgage Association, established in 1970
[56] Government National Mortgage Association, established in 1968
[57] Colloquially known as Fannie Mae, Freddie Mac and Ginnie Mae

internationally recognised law firms, further constraining the attractiveness of the sukuks to potential investors. Related to this is a lack of judicial precedent in interpreting the shariah laws in the context of international securitisation issues and that many of the laws relating to them passed by states are untested in the courts creating an atmosphere of legal uncertainty. This in turn is further exacerbated by the fact that many Islamic states do not recognize the concept of trusts, which can inhibit their capacity to utilise securitisation, which is a problem if the tax laws and accountancy regulations of the host state of the originator do not recognise offshore independent corporate vehicles as outside the scope of the originator's consolidated accounting requirements. In such instances the securitisation would only then be able to work by using a trust vehicle as a special purpose entity (SPE) to fulfill the function of an SPV.

Turning to current market practice, it is clear that the issues discussed above are being overcome, at least to some extent. Securitisations that are shariah compliant are becoming a common feature of the current market place, indeed over the last eight years it has been one of the fastest growing parts of the capital markets. The initial development was primarily that of sukuk structures incorporating a sovereign credit and corporate securitisations later followed[58]. The most widely used structure is the murabaha which is a type of sale at a marked up price. The more complex, multi-jurisdictional structures tend to involve ljara. Where shariah courts are concerned partnership structures are used[59]. The scale of Islamic securitisation is continuing to grow with an estimated US$ 44 billion issued in the last year for which full figures for securitized sukuk seem to

[58] McMillen M.J.T "Sukuk and Commercial Mortgage Backed Securities" at conference "Structuring Shariah Compliant Financial Instruments." 8 and 9 July 2008.
[59] This is particularly relevant in the Sudan, Pakistan, Malaysia and many middle eastern states.

be available[60]. However, 60% of this was denominated in Malaysian Ringgit[61] suggesting that the market is predominantly based in one geographical area. Its success there suggests that its importance will spread. Since then there is evidence of a slight downturn[62] but as the underlying reasons for this method of debt raising remain strong it is reasonable to expect further market expansion.

[60] 2012

[61] Haneef R "The case for Receivables Based Sukuk: a Convergance between the Malaysian and Global Shariah Standards on Bay al-Dayn". Kamali MH and Abdullah AK *ibid* p 144

[62] Islamic Financial Services Board, Stability Report 2016, p32