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Special Edition on Islamic Structured Finance

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Tranching of Risk and Shariah

1. Introduction

One of the hottest topics in Islamic finance is the tranching issue and its acceptability by the different Shariah schools and scholars. Why is tranching viewed by some as being non Shariah compliant when other credit enhancement techniques (similar or identical to tranching) are so widespread and accepted? What is the philosophical rationale behind such prohibition? Difficult to say.

The purpose of this article is to bring forward the debate on tranching and to highlight the need of a transparent and coherent thinking to grow and develop Islamic finance.

2. The issue

Scholars have provided mixed views on the ability to give different investors differentiated rights over the same underlying asset. The theological rational underpinning such a potential prohibition is unclear. But in any case, should the above be unlawful it would de facto stretch to all types of credit enhancement as we will see below.

3. Some definitions

Credit Enhancement:

- Refers to one or more initiatives taken by the originator in a securitization structure to enhance the security, credit or rating of the securitized instrument e.g. by providing cash collateral, profit retention, and third party guarantee. Credit enhancement could be structural credit enhancement, originator credit enhancement or third party credit enhancement.
- An instrument or mechanism that elevates the credit quality of a cash flow stream that one or more assets are expected to produce above the stream's inherent credit quality; elements within the structure of a securitization designed to protect the investors from losses incurred on the underlying assets.
- Set of right and privileges intended to reduce the credit risk by requiring collateral to the lender, reassuring them they will be compensated if the borrower defaults on its debt.

Tranching:

- Tranche is the piece, portion or slice of a deal or structured financing. The risks shared by different tranches in terms of losses, sequential payment of the cash flows, etc. are different. Obviously, therefore, the coupon on different tranches is also different.
- Is the act of taking a pool of assets referred to as the "collateral" of the deal and carving it up into several pieces.



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Subordination:

- Is the act of a party acknowledging by written record that a debt is inferior to the interest of another in the same property. Subordination may apply not only to mortgages, but also to leases, real estate rights, and any other types of debt instrument.
- Is the act or process by which a person's rights are ranked below the rights of others. For example, a second mortgagee's rights are subordinate to those of the first mortgagee.
- Is a class of securities which have lower priority or claim against a borrower. Typically, these are unsecured obligations. They are also called Junior notes and bonds. This compares to Senior securities.

4. Analyzing the different credit enhancement techniques

A thorough reading of the above highlights that tranching is (only) a credit enhancement mechanism (like many others). Tranching, subordination, reserves, over-collateralization, buy-back guarantees, discounted sale, recourse are all financial techniques designed to meet the same goal. Let us dissect each one:

- **Tranching** technique is used when two or more investors agree to take different risk/return profiles against the same collateral. In essence an investor subordinates some (but not necessarily all) of his rights to the other for a given risk premium. The term tranching is mostly used when the investors are both holders of marketable securities.
- As for **subordination**, it is the limitation of the rights of certain creditors to the full satisfaction of the rights of other creditors.
- **Overcollateralization** is another credit enhancement technique indicating an allocation of assets in amounts exceeding the size of the issuance of a bond/Sukuk.
- **Cash reserves**, excess spread and other reserves are also credit enhancement techniques based on allocation of certain amounts (whether funded from the outset of a transaction, built over time from the spread differential or under a covenant format) to pay investors in case of default or delinquencies.
- **Discounted sale** of assets are used in certain instances to ensure some type of overcollateralization. A creditor is holder of assets purchased at a discounted price sized in a way to mitigate certain expected or unexpected losses.
- **Recourse** (in a Sukuk issuance for instance) is highlighted by the simple fact that the shareholder rights to the collateral are subordinated to the rights of the Sukuk holders.

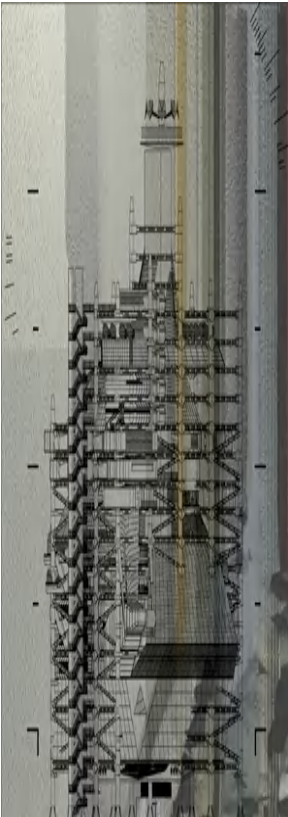
For a split of a second, one would think that these credit enhancement techniques are different in nature where in reality they are not.

5. Tranching and other credit enhancement techniques

Subordination (under covenant format or tranching format or any other legal financial device used for that purpose) is in essence a technique that is meant to rank the rights of different creditors over one single collateral. Certain creditors (whether holders of marketable securities or not) are entitled in priority to the proceeds of the collateral. Only when the senior creditors are made whole will the excess be allocated to the other creditors. This again indicates that different creditors are holding different rights over the same assets.



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Take **overcollateralization**. In case of given default, such default will first be allocated to the “junior” creditor (again tranching) until such portion of collateral in excess of the “senior” is exhausted and only then will the “senior” start incurring write offs. Conversely in case of no defaults, all the collateral redeems the Sukuk in full and the excess is allocated to the payment of the “residual” (or junior or equity or subordinated) portion. Hence the same collateral is used to pay two different creditors with different rights and remuneration. This is yet again identical to tranching.

Let us analyze **cash reserves**. In all instances cash reserves are credit enhancement to the extent that they ensure that a portion of the Sukuk are protected from default even if the ultimate collateral defaults entirely. From that perspective, Sukuk holders and other creditors have differentiated rights over the same collateral. Conversely, if the collateral does not default the cash reserve goes back to the holder of a subordinated right to the Sukuk holder. The cash reserve is hence a collateral over which at least two creditors have rights with one creditor being subordinated in his rights to the other.....exactly as tranching!

Discount selling is yet another technique to achieve the same goal. This mechanism is based on selling assets for less of their market value which is in substance similar to risk tranching since it simply makes the seller of assets bear a part of their risk instead of the investors. An accounting reading of such an operation clarifies the tranching element in this practice. Absent any default and after all the collateral has paid the Sukuk in full and the excess is allocated to the payment of the “residual” (or junior or equity or subordinated) portion.

Where the credit enhancement comes in the form of recourse to the company (asset based Sukuk), a default in the underlying assets triggers a senior right for the investors to the company collateral which results in different creditors having differentiated rights over the same collateral. This is clearly creating different risks profile out of the same pool of assets.

All of the credit enhancement techniques create differentiated rights to different investors over the same (or a same) collateral and as such are identical to tranching.

6. Credit enhancement and Islamic finance

A review of most existing Islamic finance deals, including capital market transactions and Sukuk, highlights the widespread implicit or explicit existence of tranching. Certain Sukuk structures like Salam Bounian Development Company Sukuk limited, Villamar Sukuk Company Limited, Tabreed, Sabic, Caravan I, East Cameron, and others benefit from credit enhancement in the form, inter alia, of cash reserve, Overcollateralization, discounted sale, etc. resulting in differentiated rights to different investors over the same collateral. The following table illustrates the implicit tranching of risk:



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Transaction Name	Credit Enhancement type	Deployment mechanism	Tranching of risk evidenced
Tabreed	Subordination	“Upon an Insolvency Dissolution Event, the Trustee’s claim for an owing by Tabreed in respect of any obligations under the Transaction documents is subordinated to the claim of Senior Creditors of Tabreed, in that all claims of Senior Creditors must be paid in full before such claim is paid”	Tranching is evidenced by the subordination of the Sukuk and the other Creditors over the proceeds of the same collateral. Furthermore the Sukuk are senior to Tabreed Capital.
Salam Bounian Development Company Sukuk limited	Reserve Account	“in the event that the credit balance of the Reserve Account [...] Salam Bounian will pay into the Reserve Account such amount” “The Issuer shall from time to time be entitled to transfer the amounts standing to the credit balance of the Reserve Account to the Preceeds Account to meet the payments [...] in the payment waterfall...”	The deployment mechanism evidences that a part of the default risk in the assets is borne by the reserve account to protect the Sukuk holders. This account is funded by the originator which means that the risk of default in the assets is tranching between the investors and the originator with no differentiation in the underlying assets. Also, the same collateral is used to pay the Sukuk and then the other creditors.
SABIC	Reserve account	“Pursuant to the Sukuk Assets Administration Agreement, the Issuer shall retain the Reserve and pay monies standing to the credit if the reserve (if any) as provided in [...] firstly, towards the aggregate amount of any shortfall between the amounts paid to Holders on any previous Periodic Distribution Date(s) and the corresponding Periodic Distribution Amount(s) for such date(s)...”	It is obvious that amounts in the reserve account will be used to protect the Sukuk holders from a default up to a given threshold. This means that the risk emanating from the underlying assets is tranching between the Sukuk holders and the issuer.
ECP	Reserve account	“The Purchaser SPV will apply such amounts to fund [...] the Reserve Account with an initial balance of ...”	This evidences that the originator is funding the reserve account to protect the Sukuk holders, which is similar to tranching the risk of the assets between two investors.
Caravan I	Overcollateralization	“Retainer on Purchase: means the portion of the purchase price of the Purchased Assets to be withheld by Al-Karam until the first Funding Payment Date following the redemption of the Sukuk.	Tranching of the assets risk is evidenced by the fact that the originator was paid less than the purchase price of the assets in order to insure higher protection to Sukuk holders.
Villamar Sukuk Company Limited	Reserve Account	“the Musharaka Partners shall permit the withdrawal from the Reserve Account of such amounts as may be required for the following items: a- [...] to the extent that there are insufficient funds in the Musharaka Collection Account to fund the same, in or towards payment of each Musharaka Partner pro rata in accordance...”	Obviously, a portion of the default streaming from the underlying assets, if any, is borne by the reserve account that is prefunded. This allocation of default between the Musharaka Partners from one side and the Reserve Account from the other is a clear tranching of risk of the assets on which the financing is based. In case of no default such amounts will revert back to the equity holder as a return.



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The same mechanism in structured finance more specifically securitization makes the investors subject to different risk profiles out of the same ring-fenced assets of the same corporation and is being viewed by Shariah scholars as being non compliant to Shariah Principle, given that no clear principal or precept forbids this practice.

The question remains as to why the principle of tranching being embedded in almost all Islamic financing schemes is not being viewed as Shariah compliant when implemented explicitly.

The objective of tranching is to issue different classes of shares/Sukuks out of the same pool of assets having different risk profiles but always referring to the same real assets and bearing their risk.

Whereas all credit enhancement mechanisms are identical in substance, the debate on the compliance to Shariah principles of one single technique hinders the development of Islamic structured finance by creating a grey area on this subject. This unnecessary and unjustified debate over one credit enhancement technique (and not the others!) comes at a time when small and medium corporations in Islamic countries are in need for financing. They are in need of efficient financing which only structured finance (and all its credit enhancement techniques and mainly tranching) can provide. Absent that, the development of these entities and their ability to compete globally and to provide employment, welfare and increased in living standards remains hampered and burdened by the financial charges of traditional financing schemes.

7. Conclusion

We owe ourselves and the Islamic finance industry to be honest and coherent. If one is lawful all are. If one is prohibited and unlawful, all should be as well.

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“We are what we repeatedly do. Excellence, then, is not an act, but a habit.”
Aristotle

BSEC Industry Awards

 “Most Innovative Islamic Finance Deal”, Jan 07

 “Structured Finance Deal of the Year”, Jan 07

“USA Deal of the Year”, Jan 07



“Runner-up: Emerging Markets Deal of the Year”, Jan 04



“Most Innovative Islamic Finance Product” Deloitte

 BSEC listed on International Islamic Bonds Managers League Table, Sept 04

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