

The future of Sukuk: substance over form?

By: Contributor

The current global crisis has allowed the Islamic Finance industry some time for reflection, and as such, when considering the future of the Sukuk market, we explore in detail the issue of substance over form.

Sukuk structures are being tested for the first time by originator insolvency¹ and proposed restructurings. In these more difficult periods it is important that all investors understand that very few existing Sukuk have asset ownership or security –the majority are unsecured. Asset-backed Sukuk or Islamic securitisations generally perform very differently from asset-based under stress.

Most Islamic market participants are aware that Sukuk, sometimes known as Islamic bonds, should grant the investor a share of an asset or business venture along with the cash flows and risk commensurate with such ownership. However, while this is indeed the Shari'ah ideal, most current structures have more in common with conventional fixed income or 'debt' instruments from a risk/return perspective. The recent highly successful Indonesian sovereign Sukuk (\$650 million) shows there is still heavy demand for these unsecured, asset 'based' structures, although the recent bonds of Qatar and Abu Dhabi were not Sukuk.



The assets in the structure are commonly for Shari'ah compliance only, and ultimately have little or no bearing on the risk or performance of the Sukuk. Investors should note that, while all conventional asset-backed securities (ABS) are not Sukuk, a true asset-backed Sukuk is accessible to the whole universe of global ABS investors, and not just to the much smaller Shari'ah compliant investor base.

Moody's recently published a Special Report on the decline in global Sukuk issuance in 2008 and referred to the possible impact from the statements made by AAOIFI early last year. Here we look at the issues raised and structural features from a purely analytical and credit risk perspective. Parties involved in such activities may find the Sukuk analysis undertaken by Moody's helpful in bringing transparency and understanding to these often complex structures.

The disparity between the 'ideal' and the 'reality' of Sukuk was highlighted by AAOIFI in February 2008, when it published six principles regarding Sukuk structures and initially noted that around 85 per cent of existing Sukuk were not in compliance with these principles. Subsequently, many sources attributed the market decline to these statements. In reality, that the decline in Sukuk market volume in 2008 was probably due more to prevailing global credit market conditions (it was a very difficult time to raise funds, whether conventional or Islamic) rather than to any direct reaction to the AAOIFI statements (as recently highlighted in our review).

Moody's 'pure' focus on credit risk, along with our extensive coverage of regional structured finance and long experience of looking at hundreds of structured transactions, may well qualify Moody's to comment meaningfully on these structures and in a way that enhances understanding of their Islamic characteristics, as we strive to strip away the sometimes excessive structural and legal complexity and confusion surrounding Sukuk products, getting to the real 'substance' of the Sukuk without being distracted by the 'form'. This focus on the substance of the risk and return is helpful when trying to assess a product's compliance with a given set of Shari'ah principles or views.

While terms such as Mudarabah, Musharaka and Ijarah are widely applied, the actual legal structure behind the 'name' and Sukuk risk characteristics can vary significantly –even within a single 'type'. Thus, until there is some broad consensual standardisation on terminology or form, investors will need to look at each structure individually to understand the cash flow, risk and return profile, irrespective of the name/type of Sukuk structure used.

The common theme of 'form over substance' throughout modern Islamic finance has, in our experience, created confusion for some market participants. 'Asset-backed' and 'asset-based' are semantically similar descriptions but mask significant differences in credit risk. 'Shari'ah-based' and 'Shari'ah-compliant' are two more recent terms that seem to add some confusion.

While there was some debate regarding the method of its release, the AAOIFI's comments constituted a positive effort towards improving transparency and bringing the 'substance' of Sukuk products

closer to the basic tangible and risk-sharing principles on which there is an almost universal consensus – it is in the implementation of these principles that matters become complex for investors. Whether or not the market agrees with the comments, at the very least it raises the right questions for those to whom such adherence is important.

A key question for participants is whether the goal of the Islamic finance movement is to essentially replicate in its entirety the conventional financial system. How wary should practitioners be of creating instruments and investments that are identical in substance to conventional ones by combining a redundant succession of trades and labelled with ‘new’ Arabic names? Or how much emphasis should be placed on innovation that encourages and favours particular types of investment (such as more tangible risk-sharing ones) and funding that is closer to Shari’ah principles, regardless of terminology and origin? For example, private equity investments in the technology companies of Silicon Valley in the US are in substance and inherently compliant with the Shari’ah investment principles, despite the absence of any Islamic terminology.

In addition, an Islamic financial market will always need to interact and engage with the conventional one – it does not exist in some ‘isolated’ bubble thus some level of ‘contamination’ may be difficult to avoid. The credit crisis has proved the globalised nature of the world we live in: imagining that a sub-prime crisis could never happen in Islamic finance would be to encourage complacency. As the Gulf countries now contemplate the effects of property and stock market declines coupled with low economic growth prospects in the short term, Islamic and conventional institutions alike are feeling the pain of reduced liquidity and credit losses.

There has been much discussion in the media about looking at alternative financial systems as various parties seek to avoid such crises in the future. While the ideals of Islamic finance offer some compelling ideas, the reality is that much of Islamic finance today is focussed on replicating the conventional system. This makes it competitive with the conventional and gives customers (financial depositors and consumers) the products they want. However, an inevitable consequence is that any problems/flaws are also likely to be replicated. The benefits of a truly alternative investment approach are more likely felt, and the industry more sustainable, when those aspects that are different about Islamic finance are emphasised and practiced.

For example, requiring assets in return for funding makes institutional debt/leverage more difficult. But where financing (vs. arbitrage) is the driver and moral hazard is mitigated, selling assets for cash may encourage some funding discipline. It is also crucial that the whole concept is religious and spiritually motivated, which brings in powerful non-regulatory drivers for ethical financing and social responsibility. To be clear, these are ideals and, at this relatively early stage in the industry there is heavy debate as to how to apply these ideals in actual practices.

The different motives of the parties involved in the industry also need to be considered – it is not always religious or moral ethics that drive the market forward. The pursuit of profit is a powerful and perhaps legitimate driver that is in keeping with human nature, but introduces moral hazards and possible conflicts of interest that need to be dealt with, or at least acknowledged. Key roles need to be institutionalised for the longer-term transparency health, future and sustainability of the industry.

Ultimately, much is subject to interpretation and opinion. Although there is no real provision for individuals (who within the faith are generally considered equal under Allah) to ‘judge’ on Islamic ‘compliance’ – as opposed to offering advice, guidance, opinions and education – the market in the Gulf, tends to follow the various opinions of a relatively small and overstretched circle of prominent scholars.

AAOIFI has its views, but market participants can, and will, make their own decisions based on the precedence given to Shari’ah compliance in their own agendas and economic objectives – where the need for financing may be the key driver. Conventional finance has had many hundreds, if not thousands, of years to reach its current form and is still evolving. ‘Modern’ Islamic finance is relatively young and following its own path before it reaches a point of stability/consensus. From a Shari’ah perspective, it may be the sincere niyyah or intention of the parties that is probably the most important.

Asset-‘Based’ vs. Asset-‘Backed’: Is There a Difference?

The first point highlighted by AAOIFI relates to assets. It proposes that Sukuk investors should have rights over the Sukuk assets, that they should be sold ‘legally’ and that the originating company should ‘transfer’ the assets. This is not the case in the majority of Sukuk issued to date – although we have seen a couple of notable Islamic securitisations where the assets were ‘truly’ sold: Tamweel and Sorouh PJSC, both UAE transactions. They still account for the minority of overall issuance at less than a few billion of an approximate total of \$85 billion issued to date.

This point derives from the fact that Shari’ah promotes the concept that financing should be raised only for trading in, or construction of, specific and identifiable assets. Trading in general ‘indebtedness’ is prohibited, and therefore the issuance and trading of conventional bonds is not seen to be compliant. Conventional bonds usually represent non-asset-backed interest-based funding for

general corporate purposes.

Thus, it is encouraged that all Sukuk returns and cash flows be linked to assets purchased, or (in the case of project finance) those generated from an asset once constructed and not simply be income that is interest-based. This requirement for 'tangibility' has significant – and problematic – effects in other areas, such as hedging and derivatives. For borrowers to raise 'compliant financing', they will need to utilise assets in the structure. These 'companies or banks' that provide the assets are commonly referred to as 'originators'.

In essence, the key substance of a Sukuk is the return/profits, payment/cash flows of the instrument as well as risk (of loss) - how much income/profit can the investor expect to receive when comparing it to how much was due/expected? How likely is it that they will lose on the investment or that the Sukuk will default? In our assignment of ratings to such instruments, it is exactly these aspects that we analyse quantitatively, qualitatively and legally to assign our credit ratings.

It is an effort to adhere to the above principle that has given rise to the term 'asset-based' Sukuk, which in most cases actually addresses this principle in form but not in substance. Understanding the substance should be the first and most important step in any analysis, be it Shari'ah compliance or credit risk. In the majority of the Sukuk rated by Moody's, as per our usual credit analysis, we have gone in great detail through the Sukuk documentation (sometimes hundreds of pages) to understand the actual source of risk and source of the profit and principal/capital payments.

While there are many Sukuk structures (14 described by AAOIFI), the majority of those applied (be they Ijarah, Musharaka or Mudarabah) effectively 'reduce' to a form that is an Islamic equivalent of a conventional unsecured bond. Much complexity is generated by asset-based aspects of the structure, but the ultimate objective is to replicate the risk and return characteristics of a fixed income bond.

So what of the assets in these structures? Usually there is some plot of land, a building or something tangible at the heart of the Sukuk. The critical question is (as per the AAOIFI statement): is there any 'legally' recognised asset ownership or interest for Sukuk investors?

Do Investors Have Any Rights Over the Sukuk Assets?

If our analysis validates some form of asset ownership or security, then the Sukuk risk/profit is driven more by the value and cash flows of the asset. Even if the originator were to default and go bankrupt, then Sukuk investors should be in a good position to recover much of their investment, obviously depending on asset quality, i.e. if the building or land was truly sold to the Sukuk, then it is the building or land value that affects how much Sukuk investors will recover. However, if the security is property and the originator is a real estate developer, there is a significant chance that both may be impaired at the same time. In most existing Sukuk cases, the originator would actually aim to legally retain the asset in question, hence the Sukuk and is structured to effect this.

When is something 'truly' sold? Simplistically, there must be an agreement that is evidence of a binding sale transaction from the originator to the Sukuk investors. However, it does not end there. While there is a freedom of contract principle in the UAE (the most active international Sukuk market), such contract needs to be shown to be legal, valid, binding and ultimately enforceable on all parties under the laws of the country where the assets and company are based in order for Moody's to give any value to the asset security. Most often, effective registration of the property in the name of the new owner(s) is conclusive evidence of legal transfer and binding in any court process.

Moody's relies heavily on legal opinions from law firms expert in local and international law as to how the law would be expected to operate in such circumstances. If we believe that such contracts are not binding or that they are voided in a bankruptcy court situation, then we give limited value to the assets in the structure, and the risk and rating analysis is usually focussed on the issuing corporate or bank.

It is important to note that, under disclosure and securities laws and regulations of the exchanges, it is very unlikely that the 'asset' risk/return of a Sukuk will be misrepresented directly to investors. However, Moody's has met market participants who, without access to (or interest in) the legal detail, sincerely believe there is asset security and that the investment/financing provided is collateralised. We therefore believe that the term 'asset-based' is confusing; currently, we see in substance only two types of Sukuk from an asset perspective – simply secured and unsecured.

Many of the current Sukuk types adhere to AAOIFI in form, but not in substance. In Moody's efforts to provide the clear credit analysis that can help support a healthy and long-term Sukuk market, we aim to encourage as much transparency as possible so that investors are fully aware of the true nature of such securities. This helps prevent investor disputes at a later stage should the company or assets become distressed.

From a risk perspective, it is critical for investors to note that, currently, upon the insolvency of a Sukuk originator, the assets 'involved' would be clawed back into the bankruptcy estate. The Sukuk investors would have no first-lien or prior ranking or security above any other unsecured creditor. It is

this aspect that drives the rating of corporate and bank Sukuk. If the likelihood of a loss on the Sukuk is based not on the assets but on the performance of the originating company – then the rating will be the same as the company's unsecured rating. However, compared to conventional bonds, the immaturity of the market means that most of the special Sukuk mechanisms are untested in a distressed environment.

To recap, without evidence of a legal 'true sale', a local court-recognised beneficial interest or equivalent, we give little or no benefit to the assets in an 'asset-based' Sukuk. The 'form' of the risk and return may appear to be that of assets but the 'substance' may be purely that of corporate or bank risk – not asset risk. Importantly, in most cases, this is exactly what the borrowers and investors want. Many, with full knowledge and understanding, are content to transact on this basis.

Where Is the Sukuk Profit Coming From?

As Shari'ah considers money to be a measuring tool for value and not an 'asset' in itself, it requires that one should not be able to receive income from money alone. This 'self-generation' of money from money is Riba, and is typically forbidden. However, some note that it is the 'usury' interpretation that is the more relevant, i.e. when interest is applied in an exploitative (usurious) manner that can force individuals into debt traps and a cycle of poverty. This is not unique to Shari'ah - many non-Islamic countries have usury laws.

The implications for Islamic financial institutions and securitisations are that the trading/selling of debts or receivables (without the underlying asset) for anything other than par is not permissible. However, it should be noted that for some of the existing Sukuk, some Shari'ah boards appear to accept that as long as such receivables are a 'small' portion of the overall income flows, their presence is acceptable (although there is some variation in the definition of 'small').

The second point raised by AAOIFI prohibits the selling of receivables or debts. As such, in both of the Sukuk securitisations seen to date, the physical assets (land and properties that are generating the cash flows) have also been sold to the investors as well as the payments/receivables due on those assets. If Tamweel or Sorouh PJSC were to become insolvent, the legal ownership of the properties and land would reside with the investors.

Institutions such as AAOIFI and the Islamic Financial Services Board have a crucial part to play in bringing together the various parties in an organised fashion to debate the issues and reach a consensus that will ultimately lead to sufficient standardisation to meet the 'common' long-term goals of Islamic finance.

In the rated Gulf Sukuk structures, there is typically a rent, lease management income derived from the 'asset'. Under the (Ijarah) lease type agreements, the company usually agrees to pay Sukuk holders income for use of the asset and these form the periodic fixed income stream that replicates the coupon in a conventional bond.

In other structures (Mudarabah, Musharaka), there may be some cash, flows from the assets that are passed to the Sukuk holders to pay the profit. However, if there is an excess income, it is taken as an incentive fee; if there is a shortfall, the originator has (ultimately) an obligation to pay the difference. The third AAOIFI principle appears tolerate to this practice, and discourages payments or loans if there is a shortfall in the expected earnings. Thus, similar to the purchase undertaking discussed below, the investors again rely on the corporate or bank to pay their profit – not the underlying assets.

What Is the Role of Purchase Undertakings?

The purchase undertaking contracts are key in almost all asset-based structures to date. This mechanism is used to repay principal to the Sukuk investors and is generally a contract that (often with a corresponding sale undertaking) 'obligates' the originator to 'buy' back the assets at par value (i.e. independent of the 'actual' realisable asset value). This 'par' element of the purchase is discouraged in the fourth and fifth of AAOIFI's points. Repurchasing the assets at some measure of actual value – e.g. the present value of future lease income – is acceptable, as is having an unaffiliated third party (i.e. not the originator/Mudarib) agree to purchase for a nominal fixed value.

Given that the assets are unlikely to have been the subject of a legal sale initially, the main purpose of this contract is to create a payment obligation on the originator. In the event of the corporate going bankrupt, this claim can be 'accelerated' and hence investors should have a claim for this amount (i.e. the principal due).

Again, given its key place within the Sukuk structure, Moody's requires a legal opinion that supports the enforceability of the claim generated by the undertaking. Assuming the opinion is satisfactory, Sukuk investors have an unsecured claim (although Moody's has seen examples where an indemnity against the 'originator' for failure to repurchase is the ultimate and enforceable source of the claim). Crucially, from an investor perspective, such claim should rank at the same level as other unsecured creditors, both conventional and Islamic. Sukuk investors here have no priority over the Sukuk assets.

The sixth and final AAOIFI point is more operational and regards the assignment of Fatwas and approvals rather than any structural comments, noting that approving boards should be more hands-on in the documentation and execution. While good in theory, there are some practicalities that make this difficult. First and foremost, the shortage of qualified scholars means that (in the past) relatively little time can be devoted to each and every Sukuk, especially when the complete legal documentation governing the structure can span hundreds of pages.

Secondly, the complexity of English legal documentation can prove problematic even to native speakers without a legal background –most scholars are fluent first in Arabic and, in addition, have little familiarity with the civil codes or common laws involved that dictate asset rights and enforcement in the local courts. In most commercial instances, Shari'ah laws only are relevant where explicitly incorporated into the laws of the country. Only in Saudi Arabia can Shari'ah judges potentially preside over institutional and investor disputes that could arise.

Asset-backed / securitisation Sukuk

It is into this market that we have seen securitisation Sukuk or Islamic securitisations. These innovative and legally complex structures are the closest that Sukuk currently get to the financing ideals of asset ownership and risk sharing, although the structures raise another controversial topic: the tranching of different classes of Sukuk holders (i.e. each have a different rank in the allocation of profits and losses), but that will be the topic of a future report.

The critical difference is that these structures (notable are the Tamweel and Sorouh PJSC Sukuk) have a registered 'true sale' of the underlying assets to the investors. In Sorouh, the underlying title to the plots of land are transferred to the investors with the associated cash flows (payments for land purchase).

In both asset-backed cases there is no recourse back to the originators; these Sukuk should survive their bankruptcy. Some key features are:

- The risk of principal/capital repayment depends on asset performance, not a purchase undertaking from the corporate at nominal (or market) value.

The risk of profit payments depends on the performance of the assets, not that of the Mudarib/originator. If the assets perform badly, investors may lose profit as well as principal. If they do well, they are paid the expected profit. Even if the corporate defaults, the Sukuk holders retain the assets and the cash flows should continue.

Profit and loss allocation varies according to the Sukuk class. The senior-most classes have fixed profit rate spreads due to their less risky and more senior position in the investment. The junior-most class or equity is the most risky by far but retains all the excess variable profit that may be generated. This sharing of losses is usually done in a ratio that tries to fairly reflect the allocation of profit. In the Sorouh Sukuk, it did not issue an equity note, but returned all the excess profit beyond the due amounts to repay the capital invested in order of seniority.

The substance of securitisation Sukuk is one of asset ownership and risk sharing (of the assets and associated cash flows) and satisfies many of the AAOIFI principles. Again, it should be highlighted that the structural 'substance' of many existing unsecured Sukuk is a deliberate construction; many companies do not want to 'sell' their quality assets to investors, many investors do not actually want asset risk, but want the equivalent of conventional bonds. Widespread structuring approaches mean they get the desired debt funding in Sukuk form and investors are happy with this for the most part.

It should also be emphasised that while certain sectors of securitisation have recently fallen into disrepute, the financing technology applied is still a critical part of the global landscape and even part of Central Banks' current solution to the liquidity crisis. As in many other (less complex) markets, losses in the sector are usually the result of very high leverage and an unexpectedly rapid decline in the quality of underlying assets. Leverage and credit quality are not new concepts, but the form was unfamiliar to many investors. A total loss of confidence is another key driver. Securitisations are relatively new in the Middle East, but Shari'ah could become a key positive driver of such transactions if Sukuk compliant with the AAOIFI guidelines become favoured by investors.

The future for Sukuk structures

That some Sukuk have been successfully issued since the publication of AAOIFI's comments without adopting their recommendations shows that there is still a diversity of opinion and, with a topic so subjective, no single agency, institution or individual can really hope to unilaterally 'legislate' Shari'ah law. Indeed, the success of Indonesia's recent sovereign Sukuk shows that there is strong demand (although it is not clear how much was sold to Islamic investors for whom compliance would actually be a consideration). The Islamic view is that only through Ijtihad (mental effort/struggle/evolution /reasoning) will the market reach consensus. However, the healthy debate triggered by AAOIFI and this paper is hopefully a good starting point for the next evolution of Sukuk.

Rapidly changing market conditions and unprecedented events are all playing a key part in reshaping the Sukuk markets. At the moment, the infant bond, Sukuk and debt market growth has stalled awaiting some stability in pricing and a return of investor confidence. But, given the long-term local need and sizeable Muslim populations in Europe, the Middle East, Africa and Asia, it is just a matter of time before growth resumes, although the recent conventional bond issuances from Qatar and Abu Dhabi is an ambiguous sign for GCC Sukuk markets.

As they stand, the first five AAOIFI recommendations encourage movement away from the bulk of current unsecured structures towards secured, asset-backed ones. This complements the broader trend towards more secured lending that is evident currently across the region but perhaps not the broader demand for debt finance that is needed in any developing capital market.

While securitisation Sukuk are closer to the Shari'ah ideals, they are still not perfect, and if interest and evolution continues, we will likely see more hybrid equity type structures where the some element of the profit on all (asset-backed) Sukuk classes may potentially vary from the the expected return.

In the midst of this global turmoil and the market pause, the AAOIFI comments have provided for some self-reflection in the industry, in particular among the scholars whose role in the market is currently crucial. Although it would probably be more beneficial in the long term if such Fatwas were provided by institutions, it will likely be these highly respected and learned individuals who will, in some form, drive the shape of the market for some time.

For the long-term health and sustainability of the market, Moody's believes all parties need to be very clear about the 'substance' of the underlying Sukuk risk in question to avoid the situation where some parties will be confused/distracted/misled by complex Islamic terminology or legal jargon.

If the key features of cash flows, risk and return of certain Sukuk are, in substance, the same as those of an interest-bearing conventional bond, then it may perhaps be best to make this clear to Sukuk scholars and investors at inception. One result of such transparency may be that the Sukuk market does not grow as fast as before, another that the asset-backed market may take a greater share of future volume. Regardless, rather than replication, it is probably only by supporting and encouraging those features that make Islamic finance different will it likely add any sustainable and long term value to the global financial system.

A tale of two Sukuk - Tamweel PJSC asset-'backed' vs. asset-'based'

In the Tamweel asset-backed Sukuk, the freehold titles to approximately 1,000 properties are transferred to the Sukuk investors along with the associated Ijarah cash flows; these are the Sukuk assets. The property/land titles are registered in the name of the investors at the relevant land department. Any losses on those cash flows (that ultimately arise from the sale of distressed property) are passed on to Sukuk holders, who are exposed to the asset risk. Even upon the insolvency of Tamweel, the assets will continue to pay the Sukuk investors. The Sukuk should survive. The asset-backed bankruptcy remote nature of this Sukuk means the senior notes obtain an Aa2 rating – the maximum possible in the UAE.

Tamweel also has issued an unsecured or asset-based Sukuk. The rating of this Sukuk is currently A3 (on review, direction uncertain). This is four notches below the secured one due to its asset-based nature. This Sukuk would not survive the bankruptcy of Tamweel. The two sets of Sukuk investors are taking very different risks

Legal considerations are key in Sukuk / Islamic finance

A key point from these events are that the legal details of contracts are important, and that the genuine and subjective views on Islamic ethics may be an important consideration in court enforcement situations. Such issues may be applicable to Sukuk transactions although the institutional nature of the parties involved perhaps makes social and ethical considerations a smaller part of the any judicial process. However ongoing transparency, understanding and a focus on substance are very important for long-term sustainability.

Malaysia: Domestic harmony with some recent controversy

The domestic nature of the Malaysian Sukuk market is actually a key factor underpinning its ongoing growth, as all parties (regulators, courts, scholars, lawmakers, bankers) work together more easily without concern for more nationalistic interests.

There are two Shari'ah Advisory Councils (under the Securities Commission and Central Bank) that advise the regulators on Islamic capital markets, banking and Takaful. Under the guidelines, the relevant parties generally adhere to the policies through the compliance officer, managers, trustee, etc.

The individual Shari'ah boards at local financial institutions are responsible for ensuring adherence to the Shari'ah supervisory board – but may differ with good cause. It is a clear part of the regulatory

framework and greatly helps liquidity, and brings some cohesion to the various viewpoints and transparency when comparing Islamic institutions and Sukuk products.

It is worth noting that Malaysia, which has a comprehensive domestic Islamic capital market, does not place receivables in the same category as their Gulf counterparts and hence allows Sukuk to be 100 per cent backed by receivables without any associated tangible asset. This is a major difference between the two largest markets (Far East and the Gulf) and affects the overall liquidity potential of a global 'Islamic capital market'.

Shari'ah related legal dispute – Islamic home finance contract

In multiple recent court cases the application of an Islamic asset financing method to home finance was found to be in conflict with the Islamic Banking Act (1983). Care must be taken as in some instances defaulters can possibly try use Shari'ah inconsistencies just to avoid payment – so it is important that objective legal clarity is achieved for a healthy industry.

The contract in question was the Bai al-Inah and Bai-Bithaman Ajil (BBA) contract and is analogous to a deferred payment sale. This contract is particularly prevalent in home finance contracts and is defined by the Malaysian Securities Commission as "A contract that refers to the sale and purchase transaction for the financing of an asset on a deferred and on an instalment basis with a pre-agreed payment period. The sale price will include a profit margin".

The civil court judge in question ruled there had been no bona-fide sale hence the profit element due was questionable. The profit due is calculated to take into account the full term of the financing but another key issue was that a default prior the maturity did not require the financier to forego the 'future' profit due despite the earlier recovery (and likely sale) of the property. There was much emphasis on the actual substance of the transaction -- clauses 27 & 29 of the ruling respectfully stated that:

"Transactional schemes that purport to be Islamic must be viewed as a whole rather than, by closing one eye in succession, to view the agreements in the transaction as separate components, so that the transactions are seen for what they are, before forming an opinion on permissibility."

"...it is not sufficient that the distinction between a sale and a loan is maintained in form, but it must also be maintained in substance. It is the reality and not the form and labels that matter."

Given that the goal of Islamic Finance was to encourage an ethical alternative to usurious forms of finance, the fact that (dependent on timing of default) the client could be in a significantly poorer financial position than those of a conventional mortgage was also an issue.

Ultimately an appeal court ruling on 31 March 2009 upheld the contract, and reiterated that a BBA contract is a sale transaction and therefore should not be compared to a loan transaction. This provides some comfort, but the market has started to move away from such contracts and is closely scrutinising itself.

East Cameron Asset-Backed Sukuk: Who owns the assets?

The East Cameron Partners L.P. (ECP) Sukuk was relatively small one at USD 165.67mm and was issued in July 2006. It was the first issued by a US company and was a genuine effort at an asset-backed Musharaka. It was secured by an interest in the oil and gas royalty rights on two gas fields in the Gulf of Mexico. On 16 October 2008, East Cameron Partners (the originating company), filed for Chapter 11 / bankruptcy in the US courts.

A Sukuk enforcement event was then triggered on the 3rd September 2008 due to a shortfall in the stressed [oil and gas] reserves. As an asset-backed structure Sukuk investors already have legal rights over the oil and gas assets but ECP has requested a ruling that the transaction was not a 'true sale' but a 'secured loan'. In the former Sukuk investors have sole rights to the assets in the latter they would lose their rights and share the assets with the other creditors should ECP enter Chapter 7 (liquidation).

Ultimately providing asset security for investors is a legal issue that impacts conventional and Sukuk structures equally. The concept is well tested in the US so investors rights should be preserved if structured correctly. In the Middle East, legal systems are less tested and secured Sukuk are the minority. Investors in asset-based Sukuk have no senior claim or lien over the Sukuk assets – but this is deliberate and clear to most parties.

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