

Islamic Finance *news*

The World's Global Islamic Finance News Provider

Focus

20-Jan-2010
Volume7.Issue03

Do We Really Need Standardization in Islamic Finance? (Part 1 of 2)

By Dr Sayd Z Farook

If one word has been bandied around by Islamic bankers and financiers over the past couple of years, it is standardization. It seems to have become market practice for industry professionals and conference brochures to claim that standardization is the urgent order of the day, without any of them explaining what exactly requires standardization in Islamic finance and whether it is really a desirable outcome. For instance, standardizing products in asset management could lead to a lack of innovation in the differentiated features of funds that make them the unique value proposition.

If one reviews the landscape of Islamic finance, there are essentially five major areas in Islamic finance that could be the subject of standardization. We review if there is a real potential for standardization in these areas, what can be standardized and which organization should be leading the efforts to standardize in each particular area.

Islamic commercial banking and Takaful

Islamic commercial banking has been around for the longest time (approximately 35 years) compared to the rest of the Islamic finance industry. As a result, standardization efforts — primarily led by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which has issued a combination of more than 80 Shariah, accounting, auditing and governance standards — means that much of the work in this space is done.

Issues relating to Islamic retail, corporate and trade finance products are somewhat clarified, since the majority of core Islamic banking relies on a fundamental set of contracts which has been the subject of several standards. In addition, the AAOIFI has issued standards on specialist commercial banking issues such as credit and charge cards, currency trading and documentary credits.

Nevertheless, for the industry to grow in an orderly and uniform manner while retaining transparency and avoiding regulatory capture, further efforts need to be expended in standardizing key documents and providing specific measures of investor protection.

The AAOIFI could play a crucial role in standardizing the pro-forma documentation, layout, disclosures required for the most commonly utilized contracts such as property finance, auto finance, personal finance, investment accounts, credit and charge cards and current accounts, since most of these have evolved to a level where there is not much differentiation in the core product itself, but in the features offered by each bank, which are mere add-ons to the core product.

Requiring member banks to follow standardized contracts and provide standardized disclosures to potential customers will allow the Islamic banking industry to gain a uniform advantage over conventional banks, particularly where such transparency or protections is not offered within the local jurisdiction.

The same level of standardization can be applied to Takaful products to ensure that Takaful members receive a uniform level of disclosures and sign the same type of contract (with minimal differences) for the most commonly utilized retail Takaful products such as motor Takaful, home and contents Takaful and Family Takaful.

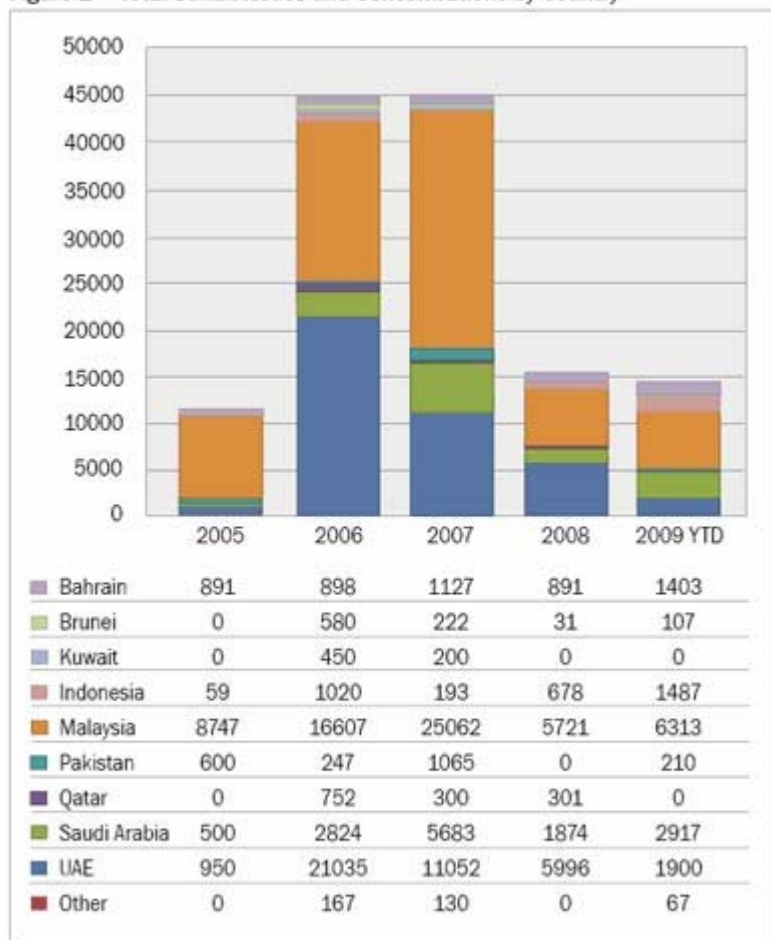
Sukuk capital markets

One would expect that the area of Sukuk has already been standardized, considering that the AAOIFI and the Islamic Financial Services Board (IFSB) have issued a number of standards for this area.

However, none of these cater to investor protection or risk-based requirements per se. The AAOIFI standard (Shariah Standard No 17 Investment Sukuk) merely provides a broader conceptual definition

of the types of contracts that can be utilized for Sukuk and the tradability status of each contract under a Sukuk structure.

Figure 1 – Total Sukuk Issues and Concentrations by Country



Note: Figures are in millions US\$. YTD is the 30th September 2009 or Q3 2009. Other comprises US in 2006 (US\$167 million), Sudan in 2007 (US\$130 million), Singapore in 2009 (US\$67 million).

Many assume that Sukuk issuances can be standardized along the lines of these contract structures. However, this is far from accurate since risks associated with Sukuk issuance do not merely depend on contract or structure, but on the particular assets and credit backing of the Sukuk. The IFSB standard goes one step further in terms of risk identification, but only does so for prudential capital adequacy purposes, rather than investor protection.

The Central Bank of Bahrain (CBB), Bank Negara Malaysia (BNM) and Dubai Financial Services Authority (DFSA) have already set in place regulations for the offering of securities and in some instances for Islamic securities. Even so, a large number are still issued by offshore entities for and on behalf of Gulf based issuers, such as those from Saudi Arabia and Kuwait.

However, there are no universal standards for Sukuk investor protection and a proper identification of risk requirements that caters to the unique structures of Sukuk issuances. Unlike conventional bonds, Sukuk issuances cannot be judged by its cover or "contract" type. A Sukuk may be based on Ijarah but may only afford minimal protection to investors since the ultimate obligors may be corporates with an opaque credit history. Alternatively, a Sukuk may invest in an equity style Musharakah contract but afford greater protection as a result of the quality of the underlying investment assets.

However, given that investors are not necessarily provided the same degree of protection across different Sukuk structures and jurisdiction, a Sukuk standard laying out a uniform set of requirements

around the standard risk-based Sukuk structures would lead to heightened investor confidence and lead to enhance the liquidity and pricing of Sukuk.

What has become evident over the past few years is that three broad classifications of Sukuk have developed out of market methodology, rather than the myriad contract structures detailed in the AAOIFI standards. One cannot assess the risks associated with each issue by merely understanding the structure such as Mudarabah, Musharakah or Ijarah, since the legal structure behind the “type of issue” and the actual risk characteristics of the issue can vary significantly, even with each structure.

Table 1: Types of Sukuk by asset recourse

Project-backed	Recourse of the investor is to the assets/ proceeds of the project and sometimes to the creditworthiness of the ultimate obligor by means of a credit enhancement feature such as a guarantee. These Sukuk rely on the value of future cash flows arising out of project completion and production/sale, the assets of the issuing vehicle and the credit of the obligor.
Asset-backed	Recourse of the investor is to the assets of the issuing vehicle and the Sukuk investors bear any losses in case of the impairment of the Sukuk.
Credit-backed/Asset-based	The recourse of the investor is to the creditworthiness of the ultimate obligor. These are also sometimes called asset-based Sukuk.

Asset-backed versus project-backed versus asset-based

It is in this context that the securitization characteristics of a Sukuk become vital to the risk assessment process. An asset-backed Sukuk implies that the ownership rights extend to the actual underlying assets such as physical real estate or rights/usufruct from particular intangible but valuable assets.

This is usually evidenced by an independent legal opinion stating that the rights to the underlying assets have been perfected through a “true sale” transfer to the issuing special purpose vehicle (SPV) and thereafter, the originator has limited or no access to such assets as part of its assets pool.

A project backed SPV, on the other hand, relies on project performance and since the returns are backed by the outcome of the project, the risks can be directly assessed by understanding the project itself. A good example of this was the “Villamar Sukuk Company” Trust Certificates issued in December 2008.

In many respects, project-backed and asset-backed securities are similar since both rely on the actual performance of the assets. These assets may perform as a result of the ultimate obligor’s credit quality (of which there may be many).


For instance, if it is a mortgage portfolio Sukuk, the obligors are several hundred customers and to understand the risk of default, one must assess the general economic indicators along with the quality of the portfolio manager’s credit risk process and systems.

Similarly, if it is a real estate development project like the Villamar Sukuk, one must assess the potential for repayments by the end users/obligors, which will solely require an assessment of the credit quality of the end users as opposed to the manager’s credit quality.

Table 2: Typical Risks associated with different types of Sukuk classifications

Risk Type	Project Backed	Asset Backed	Credit Backed/ Asset Based
Shariah Compliance	√	√	√
Credit	√	√	√
Asset	√	√	
Project	√		
Rate of Return	√	√	√
Servicer	√	√	
Liquidity	√	√	√
Cash flow	√	√	
Legal	√	√	√
Prepayment Risk	√	√	√
Reinvestment Risk	√	√	√

Dr Sayd Z Farook
Senior consultant
Dar Al Istithmar
E-mail: sayd.farook@daralistithmar.com

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