

Islamic Finance *news*

The World's Global Islamic Finance News Provider

Articles

27-Jan-2010
Volume7.Issue04

Do We Really Need Standardization in Islamic Finance?

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The first part of the two-part article was on Islamic commercial banking and Takaful, Sukuk capital markets, an asset-backed versus project-backed versus asset-based.

In contrast, an asset-based Sukuk will only provide artificial ownership rights to the “usufruct” of certain physical underlying assets, instead relying on the obligor’s credit quality to ensure that the Sukuk performs. It is for this reason that these are merely credit-backed securities with no real recourse to physical assets.

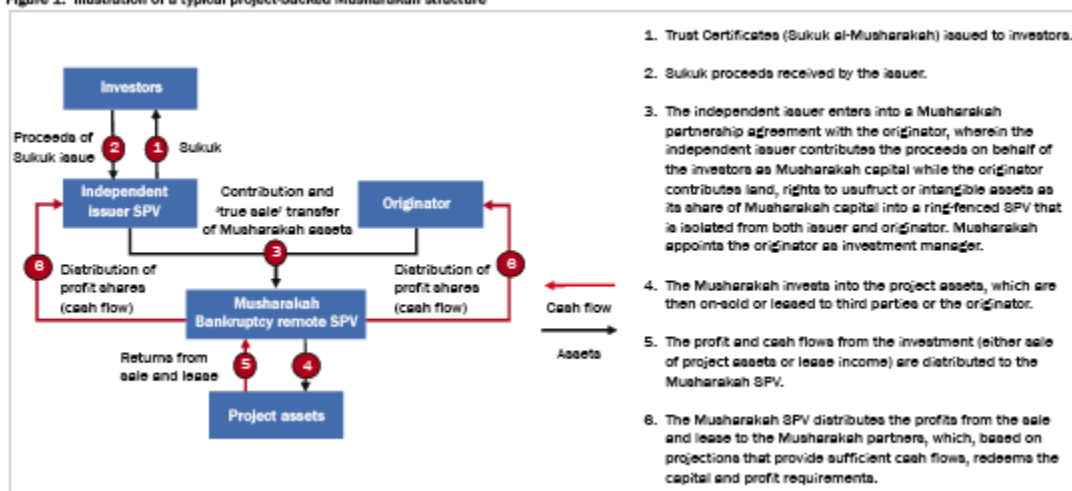
The actual sale contract providing the Sukuk holders with rights to the “usufruct” may not be the subject of a legal “true” sale and therefore investors may only be left with the strength of a purchase undertaking from the originator or an associated party to redeem the Sukuk and pay returns.

For instance, an Ijarah Sukuk may be asset-based or asset-backed, yielding a wholly different risk profile to each in the event of default and liquidation. Similarly, within Musharakah Sukuk, there can be variations between asset-based, project-backed and asset-backed Sukuk.

The originator may co-invest with the Sukuk holders trustee special purpose vehicle (SPV) in certain assets that are ring-fenced into a separate SPV that holds the assets for the purpose of the Musharakah. This would be classified as an asset-backed structure.

In contrast, in an asset based Musharakah, an originator as a Musharakah partner may only notionally provide its own assets or management labor as contribution, without appropriately ring-fencing any particular Sukuk assets thereby placing the investors at the end of the line with other unsecured equity holders, in the event of default.

Figure 1: Illustration of a typical project-backed Musharakah structure



The role of standard setters

It is in this context that regulators and standard setters such as the International Islamic Financial Market (IIFM) can contribute significantly to reducing the costs for issuers and reducing the perceived risks for the investors thereby leading to a Malaysian-style active, liquid and deep capital market for Sukuk.

By creating a standard set of documentation for Sukuk issuances with a minimum required information set — while documenting rigid and standardized structures for the most frequently issued structures — will do a lot to

enhance the liquidity and primary market issuances of Sukuk.

The standard for Sukuk issuance could include as a minimum:

- The acceptable structures of Sukuk issuance approved by a broad consensus of Shariah scholars.
- The type of Sukuk issued: Asset-based/credit-backed, asset-backed or project-backed and key disclosure requirements to be addressed for each type of Sukuk.
- Requirements for the contents of the offering circular (OC) (in addition to the requirements above) which could include: structure, structure explanation, fatwa of the Shariah supervisory board and scope and rationale for Sukuk approval, key risk factors, credit enhancement features, payment waterfall, seniority status and legal opinion of asset transfer and independent valuation report.

Islamic funds and asset management

The establishment of several Islamic investment banks and companies in the Middle East has caused an associated proliferation of listed equity, private equity, real estate and, more recently, hedge funds and structured products into the market. As with Sukuk issuance, the market is witnessing regulatory consolidation.

However, the effect of the regulatory consolidation is stronger in the asset management industry. Besides the active supervision of all investment funds in jurisdictions such as Bahrain (Central Bank of Bahrain) and Malaysia (Securities Commission Malaysia) for several years, the establishment of the Capital Markets Authority in Saudi Arabia, the Dubai Financial Services Authority at the Dubai International Financial Center and the Qatar Financial Center Regulatory Authority has meant that future issuances to the majority of investors in the Middle East will be regulated and supervised.

To this extent, Islamic funds issued out of these jurisdictions pose fewer standardization requirements, since private placement memorandums and offering memorandums for listed securities are required to fulfill certain criteria, which generally follow the recommendations of the International Organization for Securities Commissions (IOSCO) and therefore provide a sufficient level of standardization. That said, regulators in the region would do well to better regulate and supervise closed-end private equity and real estate funds, since many of these have deceptive structures that build in significant profits for the fund manager while providing lower than average returns for the associated risk.

Structured products and Shariah compliant derivative equivalents

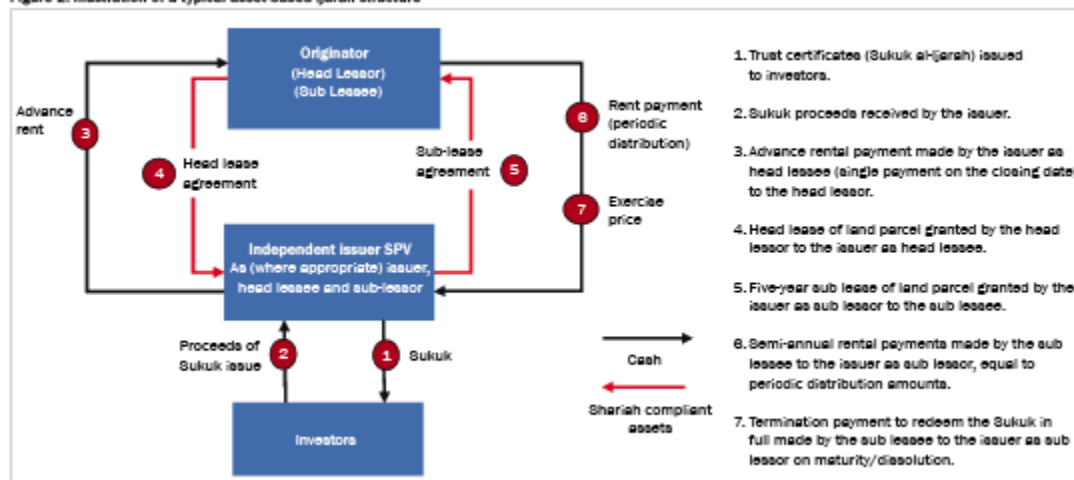
With assets in Islamic finance estimated to grow to nearly US\$1.6 trillion by 2013, it's no surprise that banks are increasingly focusing on offering Shariah compliant derivative equivalent (SCDE) hedging and investment products.

In the last half a decade or so, mechanisms to replicate such derivative financial instruments of the mainstream financial system has emerged as the new frontier of Shariah compliant "innovation".

Discussed at both conferences (academic and practitioner) and around water coolers in investment/wholesale banks, the profit rate swap has attracted the majority of deserved attention.

Multinational financial institutions such as HSBC Amanah, BNP Paribas, Standard Chartered, JPMorgan and Calyon have all prioritized the roll-out of Shariah compliant profit rate swaps over the last couple of years.

Figure 2: Illustration of a typical asset-based ijarah structure



Standardization of documentation for Shariah compliant hedging

The IIFM's efforts to promote the standardization of Islamic capital markets documents will be crucial to the continued growth of Islamic capital markets. The Master Murabahah Agreement for Treasury Placement (MATP) has already gained critical mass in terms of usage, with several Islamic banks adopting it as their standard document for interbank Murabahah transactions.

The use of this agreement will substantially ease the time and cost of executing treasury placements between financial institutions on a Murabahah basis.

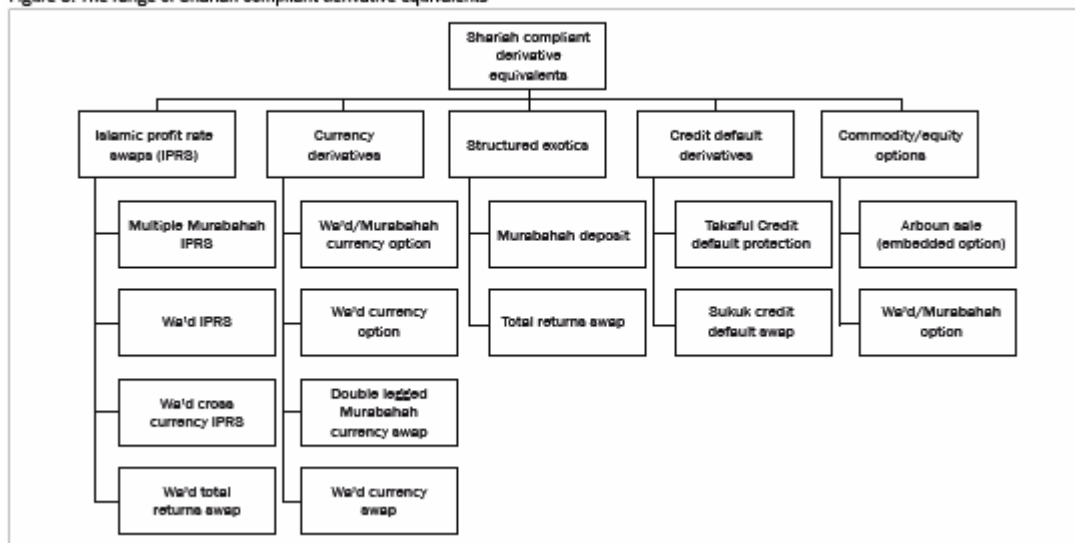
At the same time, the Tahawwut Master Agreement (TMA), which has been under development over several years in conjunction with the International Swaps and Derivatives Association (ISDA), has finally been approved by most of the IIFM members and the Shariah Supervisory Board and it is likely that the agreement will be increasingly utilized in the future.

While the TMA was originally intended for the Islamic Profit Rate Swap, its use could naturally extend to other Islamic currency options and swaps, since the agreement only requires minor adjustments to accommodate the cross currency clauses.

By introducing the TMA, market players will be able to speed up the time and cost incurred to execute a swap agreement, which is currently a long and arduous process.

Lawyers have to redraft ISDA master agreements to comply with the Shariah and transaction particulars each and every time with significant variations in the terms and clauses for each deal. This process usually takes at least a month, if not more, to execute and quite a significant amount in lawyers' fees for both parties.

Figure 3: The range of Shariah compliant derivative equivalents



Opportunities for further standardization

While the IIFM-ISDA TMA heralds the introduction of the first consensus-based standard "derivative equivalent" document in Islamic finance, there is much left to be done and the IIFM has a much more significant role to play than it is playing now.

The industry has already seen a consolidation of the types of SCDE on offer in the market (see Figure 8). It would be valuable for the IIFM to prepare standard requirements for each in terms of structures, documentation (master agreement, product supplement and confirmations templates) and Shariah compliant transaction processes.

While the Islamic finance industry appreciates diversity in the asset management business particularly to promote innovation, it is more important for risk management and treasury that the volume based contracts such as Islamic currency swaps, forwards and options and Islamic profit rate swaps are standardized.

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