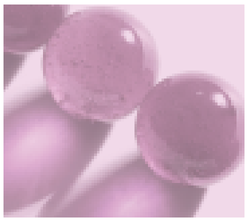


A call for clarity

PROSPECTS ARE BRIGHT FOR ISLAMIC BONDS, ACCORDING TO A RECENT MOODY'S REPORT, ALTHOUGH INVESTORS SHOULD BE WARY, AS **GRAHAM BUCK** EXPLAINS.

Executive summary

Popular though Islamic finance is, the sukuk market is falling short of the shariah ideal and a lack of standardisation leaves elements of risk for the investor. Whether or not Islamic finance aims to replicate conventional markets, the wider world is unavoidable to a degree, although the link to assets is a core consideration. Greater transparency and maturity will help the system return to growth.

The economic crisis has allowed the Islamic finance industry time for reflection. High on its list of considerations is the future course of the market for sukuk (also known as Islamic bonds), according to Moody's Investors Service.

The ratings agency's recent report, The Future of Sukuk: Substance over Form?, concludes that the sukuk market is falling some way short of the shariah ideal.

According to the report's author, Khallid Howladar – who is vice president, senior credit officer, for asset-based and sukuk finance at Moody's – the insolvencies and restructurings that have been such a feature of the credit crunch are giving sukuk structures their first serious test. He says that in tougher economic times investors should be aware that very few sukuk have asset ownership or security, and that the majority are unsecured.

Most Islamic market participants know that the intention of sukuk is to grant the investor a share of an asset or business venture, along with the cashflows and risk commensurate with such ownership. But while this complies with shariah principles, most current sukuk structures have more in common with conventional fixed income or debt instruments from a risk and return perspective.

In April, Indonesia announced its first shariah-compliant $650m sovereign sukuk, thereby reopening the global dollar-denominated sovereign sukuk market, which had been closed for more than a year. It met with an enthusiastic response. Howladar says: "There is still heavy demand for these unsecured, asset-based structures." Other recent bond issues, by Qatar and Abu Dhabi, didn't qualify as sukuk.

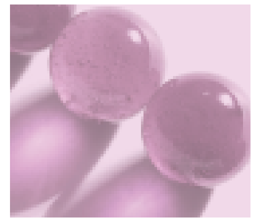
But while the assets in a sukuk structure are commonly there to achieve shariah compliance, ultimately they have little or no bearing on either the risk or performance of the sukuk, Howladar points out.

The disparity between the ideals and the reality of sukuk was the subject of a report in February 2008 by the Accounting Auditing Organisation for Islamic Financial Institutions. AAOIFI outlined six principles applying to sukuk structures (see Box 1) and noted that around 85% of existing sukuk weren't fully compliant with shariah requirements.

As it happened, the publication of the report was followed by a decline in global sukuk issuance, although Howladar suggests the drop-off reflected prevailing conditions in the global credit market more than AAOIFI's comments. Moody's nonetheless regards the six principles as "a positive effort towards improving transparency" in introducing a tangible and risk-sharing element, which enjoy a broad consensus, to the substance of sukuk products.

But actually implementing the six principles is easier said than done and matters can become complex for investors, suggests Howladar. Terms such as mudarabah, musharakah and ijarah are widely applied for all types of sukuk, although the actual legal structure and risk characteristics can vary considerably even within a single type.

"Until there is some broad standardisation, investors will need to look at each structure individually to understand the



risk/return profile irrespective of the type of sukuk structure used," Howladar warns.

ENGAGING WITH THE CONVENTIONAL MARKET

Moody's suggests that investors intending to participate in the Islamic finance market should question the objective of that market, and whether it necessarily seeks to replicate the West's conventional financial system in its entirety. As Howladar points out, private equity investments in Silicon Valley tech companies in the US are inherently compliant with shariah investment principles, even though they don't brand themselves with any Islamic terminology.

In addition, as an Islamic financial market can't operate in a bubble, it inevitably has some interaction and engagement with the conventional market and is unable to avoid some level of what might be regarded as contamination. The pain of reduced liquidity and credit losses are felt by Islamic and conventional institutions alike.

Howladar goes on to observe that the downturn has spurred much media discussion on how alternative financial systems might avoid future crisis. But he notes: "While the ideals of Islamic finance offer some compelling ideas, the reality is that much of Islamic finance today is focused on replicating the conventional system."

This ensures that the Islamic finance market can compete effectively and gives both financial depositors and consumers the products that they want. But it also means that it replicates any flaws or problems of the conventional system.

"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," Howladar concludes.

Offering an example, Howladar points out that requiring assets in return for funding makes institutional debt and leverage more difficult. But where financing (rather than 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 sukuk concept "is religious and spiritually motivated" in order to introduce powerful non-regulatory drivers for ethical financing and social responsibility. However, there is still much debate on how these ideals can be applied in practice.

Another potential obstacle is the differing motives of the parties involved in the financial industry, with the pursuit of profit a more powerful market driver than religious or moral ethics. At the same time, it introduces moral hazards and potential conflicts of interest that need to be faced. This requires key roles to be institutionalised for the long-term health and sustainability of the industry.

Box 1: AAOIFI's six principles for sukuk instruments

Principle 1: Sukuk investors should have asset ownership.

Principle 2: To be tradable, sukuk should not be backed purely by receivables.

Principle 3: Sukuk profit should not be supported by the mudarib (usually the borrower).

Principles 4 & 5: Asset purchase undertakings for par value are discouraged unless the entity is unaffiliated to the original asset owner.

Principle 6: More detailed oversight from scholars should be encouraged to ensure compliance.

IN TOUGHER ECONOMIC TIMES INVESTORS SHOULD BE AWARE THAT VERY FEW SUKUK HAVE ASSET OWNERSHIP OR SECURITY, AND THAT THE MAJORITY ARE UNSECURED.

Ultimately, while AAOIFI's views have some bearing it will be sukuk investors who decide the market's future, suggests Moody's. While conventional finance has been evolving for many hundreds of years, modern Islamic finance is relatively young and has probably yet to reach a point of stability or consensus. "From a shariah perspective, it may be the sincere niyyah or intention of the parties that is most important," says Howladar.

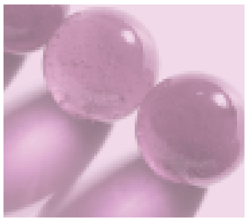
A CRITICAL LINK TO ASSETS Among AAOIFI's proposals is that sukuk investors should have rights over the sukuk assets, that they should be sold legally and that the originating company should transfer the assets. Most sukuk issued to date have, in fact, met these criteria, although a couple of Islamic securitisations in UAE did result in the sale rather than the transfer of the assets.

Shariah 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, so the issuance and trading of conventional bonds is not regarded as compliant. Ideally all sukuk returns and cashflows should be linked to assets purchased or, in the case of project finance, generated from an asset once constructed – and not simply be income that is interest-based.

This requirement for tangibility produces problems in other areas, such as hedging and derivatives. For borrowers to raise compliant financing they need to utilise assets in the structure. These companies or banks that provide the assets are commonly referred to as originators.

Moody's own analysis of a sukuk – and its assignment of a rating – focuses on the return/profits, payment/cashflows of the instrument and the risk of loss. The basic questions are how much income, or profit, the investor can expect to receive when set against how much was promised, and how likely it is that they will lose on the investment or that the sukuk will default.

Efforts to adhere to the basic principle of sukuk have produced the term "asset-based sukuk", which addresses the principle in form but not in substance. However, understanding the substance is vital, even though it may entail scouring hundreds of pages of sukuk documentation to establish the source of both the risk and the profit and principal/capital payments.



Although AAOIFI describes a total of 14 different sukuk structures, most effectively reduce to a form that is the Islamic equivalent of a conventional unsecured bond.

While the asset-based aspects of the structure produce considerable complexity, the ultimate objective is to replicate the risk and return characteristics of a fixed income bond. The assets are tangible, such as a plot of land or a building, but usually there is no legally recognised asset ownership or interest for sukuk investors. So do they have any rights over the assets?

According to Moody's analysis, sukuk risk/profit is largely driven by the value and cashflows of the asset. If the originator went bankrupt, then sukuk investors should be well positioned to recover much of their investment, depending on the asset quality. However, this might not be the case if the security is property and the originator a real estate developer, when it is likely that both originator and investor would be impaired simultaneously.

ASSET-BASED SUKUK ADDRESSES THE SUKUK PRINCIPLE IN FORM BUT NOT IN SUBSTANCE. HOWEVER, UNDERSTANDING THE SUBSTANCE IS VITAL, EVEN THOUGH IT MAY ENTAIL SCOURING HUNDREDS OF PAGES OF SUKUK DOCUMENTATION TO ESTABLISH THE SOURCE OF BOTH THE RISK AND THE PROFIT AND PRINCIPAL/CAPITAL PAYMENTS.

NEED FOR GREATER TRANSPARENCY As most current sukuks adhere to AAOIFI in form but not in substance, Moody's is keen for greater transparency, so that investors are fully aware of the true nature of the securities. This will, it suggests, reduce the potential for investor disputes should the company or assets become distressed and support a healthy and long-term sukuk market.

Howladar says that asset-backed and securitisation sukuk are "innovative and legally complex structures" that are the closest that sukuk currently gets to the shariah and AAOIFI principles. But even here there are complications as the structures raise the topic of the tranching of different classes of sukuk holder – each has a different rank in the allocation of profits and losses.

Nonetheless, securitisations are relatively new in the Middle East and Moody's predicts that shariah could become a key positive driver of such transactions if investors start to favour sukuk that comply with the AAOIFI guidelines.

THE FUTURE OF SUKUK STRUCTURES As Howladar notes, a number of sukuk have been successfully issued since AAOIFI published its recommendations, but without being adopted. The market continues to reflect a wide diversity of opinion and "with a topic so subjective, no single agency, institution or individual can really hope to unilaterally 'legislate' shariah law". The Islamic view is that only through ijtihad (mental effort or reasoning) will the market reach consensus, but rapidly changing market conditions and unprecedented events are accelerating the rate of change.

The report concludes that there is currently a lull, awaiting the return of stability in pricing and investor confidence. But "given the long-term local need and sizable Muslim populations in Europe, the Middle East, Africa and Asia, it is just a matter of time before growth resumes".

In the meantime AAOIFI's comments have provided some self-reflection in the industry, "in particular among the scholars whose role in the market is crucial". While it would probably be more beneficial if institutions were the guiding force, it's likely that these "highly respected and learned individuals" will influence the shape of the market for some time to come.

Graham Buck is a reporter for The Treasurer.
editor@treasurers.org