ASR ROUNDTABLE

The Promise of Islamic Finance

An ASR roundtable looks at this rapidly growing market's development and its future

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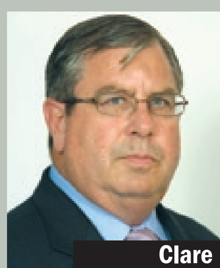
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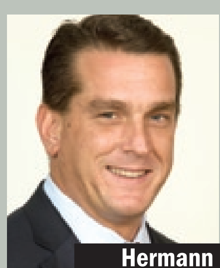
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Islamic finance had its start in the 1960s and 1970s with the influx of petrodollars into the Gulf region. The rapid development of Middle East markets — Saudi Arabia, Kuwait and the United Arab Emirates — has stoked interest in a type finance that is based on the principles of Shari'a. Industry experts estimate that Islamic finance has enjoyed double digit annual growth with nearly $1 trillion put to work in Shari'a structures.

This summer several experts came together to talk about the development of Islamic finance, some of the structures used by its market participants and examined this developing market's future. The discussion was moderated by **Aleksandrs Rozens**.

ASR: *What is Islamic finance and how do we define it?*

ARNHOLZ: Islamic finance is a financial system that is compatible with key concepts of Islamic culture and society. It's based on principles of Shari'a, which, of course, provides the framework for Islamic societies. It's important to recognize at the outset that Shari'a scholars have no objection to the important role that finance plays in a society's economic life. Instead, finance must operate within certain principles, which is really very similar to what you have in the West. We have our own principles and guidelines within which our financial institutions must operate.

Modern Islamic finance really began in the sixties and the seventies with the huge influx of petrodollars into the GCC region and the development of the Islamic Development Bank, which was formed, among other reasons, to promote Shari'a-compatible financial principles.

WIPPERMAN: The only thing I would add is that Shari'a is more than just law — it's ethics, it's religion and it's law, and I think of Islamic finance as focusing on the law part more than the religion. It is really an attempt to bring the finance and the law into sync with the religion and the ethics.

MALOUF: I think you need to bear in mind that Shari'a is, basically, especially in the Middle East, an all-encompassing way of life. It governs everything that is done in many countries in the Middle East, particularly in Saudi Arabia, and in countries like Kuwait and the United Arab Emirates.

CLARE: Is Shari'a law codified in any sort of way, or do we rely on scholars to interpret each transaction?

WIPPERMAN: Unfortunately, at least from my perspective, it's not codified. The AAOIFI — the **Accounting and Auditing Organization for Islamic Financial Institutions** — has published certain Shari'a standards. My own personal view is that one of the drawbacks to future development is that the principles generally are not codified and vary from scholar to scholar.

ARNHOLZ: Adam knows more about this than I do, but I would also say, Mike, that there are differences of opinion which, I am sure we'll come back to later when we talk about Sukuk, but there are different and evolving views on what is a compliant financial product.

There has been tremendous growth over the past several years in Islamic financial circles. I keep seeing the statistic that Islamic finance has been growing at a rate of 15 to 20 percent a year, with over 800 billion U.S. dollars now deployed in Shari'a structures. There is also a substantial and developing variety of commercial business-to-business finance, as well as consumer finance. The other statistic I came across — I think it's from S&P — is that 20 percent of all bank customers from Islamic cultures living in the West would choose to put their money in an Islamic bank account if it were available.

***ASR:** What are the drivers of the interest in Islamic finance?*

John Arnholz

Sukuk are Islamic bonds that resemble, in many respects, a conventional Western securitization. They have had spectacular growth over the past couple of years. Current outstanding Sukuk are approaching $90 billion which is expected to increase to $150 billion by 2010 by some estimates. Sukuk offerings are typically oversubscribed by three times.

MALOUF: What we have seen in this part of the world in terms of rapid economic growth, apart from the fact that there are increasingly a number of Islamic finance institutions popping up, requires us to go back about seven years or so when the tragic events of 9/11 took place. What happened after that was that there was a lot of repatriation of capital back to the Middle East region. And that, in itself, from an investment perspective, has, to a certain extent, driven the growth in Islamic finance and in Islamic finance products. You are seeing a lot more issuances of Sukuk in this part of the world where previously these types of products were issued out of jurisdictions such as Malaysia, which has traditionally been the center of Islamic finance and Islamic products. And that has moved somewhat away from there towards the Gulf Region, where you are seeing issuances of the Sukuk on a fairly regular basis, and you are seeing the rise of other Islamic finance products, such as Ijara lease structures and quasi-Islamic securitizations, which I am sure we will touch upon later. So I think that's one of the key drivers. The investments in these products are from the region, and investors demand that these products are Shari'a compliant.

WIPPERMAN: Two other things I would add to that is, I don't think it's possible to ignore the fact that Islam is the fastest growing religion in the world and now, I believe, is the second largest, so there is quite a potential market. It also

◀ Rob Wipperman

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coincides with a growth, generally, of socially responsible investment. People are investing for all sorts of socially responsible purposes. If a product is available, and it doesn't cost you too much relative to the other product, and it's socially responsible, as the Shari'a compliant products are, you logically would choose that product. It is hard to explain why socially responsible investing is growing, but the growth in Islamic finance is consistent with that.

ARNHOLZ: There has been a lot of capital accumulated now in the GCC and it needs a home.

WIPPERMAN: As more products become available, the cost or the inefficiency "premium" probably declines. Again, if you had a choice and you weren't losing money on one, you would, obviously, choose the socially responsible one, or the one that is consistent with your religion.

ARNHOLZ: If we could just come back to the first question. I am not sure we touched on what the key principles of Islamic finance are.

WIPPERMAN: The prohibition against paying interest, or Riba, is the most famous one and probably the most well known. That prohibition is actually, not as straightforward as it seems because drawing the distinction between payment of interest versus selling a product with a markup, which is okay, is not crystal clear. I think one of the things to keep in mind, when looking at that distinction is that under Shari'a, money has no intrinsic value. It is only a means of exchange, and so money can't earn a return by itself. Paying money on money, interest, is prohibited. Some of the things that also flow from that prohibition is that risk has to be shared. You can't get a guaranteed return, which is like interest, or interest is a form of guaranteed return. You have to share the risk, and you can't guarantee the return of principal. All of these principles flow from the prohibition on Riba.

ARNHOLZ: Which, by the way, has particular application when we talk about securitized structures and credit enhancement arrangements. I think what Rob is saying is that gain must come from real economic activity. I heard someone once express it that you can't derive gain from the time value of money. Also, of course, any enterprise to be financed must be halal; you can't finance gambling or alcohol and the like.

***ASR:** What are the differences and similarities between Islamic finance and Western finance principles?*

ARNHOLZ: There are a lot of similarities. Generally, a finance system is about trying to create structures that efficiently deploy capital in the right amounts and which compensate people for those decisions. Islamic finance systems do a pretty good job of that.

WIPPERMAN: Probably the fundamental difference between Western, or conventional finance, and Islamic finance is the risk/reward system. We think nothing of selling the risk, right? I mean, we sell protection, we buy protection. We can sell the risk, or we can allocate it effectively, 99 percent/one percent, and that is fundamentally different from Islamic finance where it has to be shared. The profit doesn't have to be shared, pro rata, but the profit has got to be shared in proportion to the risk. So you do have structures where people contribute capital and somebody else contributes expertise, but they have to share the risk and that is the fundamental difference. Probably the best model for an Islamic finance structure is a partnership or joint venture.

ROBERTSON: Yes.

MALOUF: That is definitely the most optimal structure, and this is what Islamic finance advocates in the way which it is structured, in terms of sharing the risk.

***ASR:** Alasdair, you were saying?*

ROBERTSON: I think it goes back to some fundamental principles, where the partnership concept comes back to the idea that you have got a real economic business and you are sharing in those profits. So you have got to understand how that's done and then, in terms of the Western viewpoint, how do you put that into a Western style of financing. So, maybe I am jumping ahead of this, but the idea of a partnership is a fundamental way then of producing the structured product in terms of Sukuk. Whereas, in the Western world, you would set up and buy underlying assets and to buy it you have to come up with all kinds of neat hedging strategies and everything else, in Islamic finance you have to go in on a partnership. One entity brings the asset, one brings the cash, and then that cash flow is split equitably. That forms the principles we have all been talking about. So, in some ways, I think a lot of the similarities are, obviously, that once you get past the idea of the fundamental principles of Islamic finance, which is why I think it is quite important to spend further time on the fundamental principles because once you have understood those, I think you are on the path to match Western style to Islamic finance.

***ASR:** Cristal?*

JONES: Speaking from a different angle, the ratings perspective, the primary difference would really center on the Shari'a compliance, which is not a feature that we really looked to or relied upon within the ratings context of securitization. For example, for conventional financing, you are not necessarily required to recognize things such as prohibition on alcohol or limitations on the sale of financial assets or collateral use or exclusion from certain industries like gambling or alcohol. On the other hand, and similar to conventional financing, is S&P's approach to analyzing an Islamic financing structure in that we expect the bond to be paid according to the terms of the structure, and satisfy the applicable commercial laws. Also similar to conventional financing, S&P would expect to review all credit and legal considerations befitting the asset, the issuer and the structure.

ROBERTSON: Cristal, just to add for a moment, if I could just jump in with one thing, I think I could help on the ratings side. The vehicle to choose with Sukuk is an SPV in the normal way you would see an SPV used on a securitization or a CDO or whatever else. That side of things is very similar, so I think that helps in terms of ratings, the bankruptcy remoteness, and things like that.

CLARE: I would like to ask if ratings are in wide use in Islamic finance? Are they generally expected?

MALOUF: We are seeing that more and more Islamic products, especially Sukuk, are being rated, for the same reasons that conventional products are rated. In other words, a rated product attracts better pricing and it makes it more attractive to investors, from this perspective and also from a transparency and corporate governance perspective. However, there are Islamic products, which are not rated. Despite today's negative financial and economic environment, especially with the state of the debt market at the moment — and, Cristal, correct me if I am wrong — you would still do well to have rated products issued. For example, in Abu Dhabi recently, **Sorouh**, which is one of the large master real estate developers, issued a quite substantial Sukuk, which was combined with a receivables securitization. The total value of the deal was probably around $1.1 billion. So when you are looking to raise that much capital, ratings, or, more specifically, ratings on a class or class of notes are essential.

VISSER: From an investor perspective, since these markets are just starting off, they are in the baby steps, there is a lot of reliance on, or a large portion of the investor base is, Western style investors. There is an overlap, or at least what we have seen, in that the Western product has been adapted to be compliant with the principles of Shari'a, and ratings are very important for investors to be able to put this into their portfolios.

CLARE: But are you suggesting that ratings play a greater role for the non-Shari'a investor to fill out the book than the Shari'a investor?

ARNHOLZ: To follow your point, the last time we were in Dubai, we were astonished by the very substantial presence of all three major rating agencies and of all the investment banks. The agencies are active, and — Adam could speak to this more than I can — the GCC investors are now relying more and more on ratings than had been the case. One of the things that Rob and I talk about from time to time is the enormous complexity of some of these structures — they really do look like some of the structured products that we have seen over the past several years. For people who are familiar with white boards filled up with triangles and rectangles, they look very, very familiar.

ROBERTSON: I think one of the interesting elements that the ratings shows is that the market is developing. Though I think it is in infancy, I think you were saying it is growing 15 to 20 percent per annum, and naturally I think more structures, newer structures that we see in the West will be

Cristal E. Jones

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adapted in this market. To date all Sukuk issues have been done using a single issuer. One of the natural things that we are waiting for and think may happen is for people to want to do multi-issuers in the same way that you do a note repackaging in multi-issuer vehicles under English law out of London. It strikes us that at some point in time someone will want this in the Middle East. So I think it is very much a market that, if watched carefully, is a very exciting and developing market. And I think there are structures, including ratings and multi-issuance, that we will see. And another feature as well that I think will be an interesting one, so far I certainly haven't seen, is a Sukuk which has redeemable features put into it. That is something, again, that may happen in due course.

ASR: *So it sounds like you could have a conduit that takes a product from different originators.*

ROBERTSON: From a structural perspective it can be. The question then is, is the market appetite, the market risk at a point yet where people want to do that?

ARNHOLZ: Alasdair, if I can follow up, I am intrigued by your comment about doing a "repack" type of transaction. We have had trouble seeing how to get there, but you think that is something that may be structured?

ROBERTSON: I think it may be. I mean, a lot of the Sukuk, again, that we have seen to date, albeit the governing law has been English law, really are a type of repackage from a legal perspective. The SPV is issuing a form of trust certificates, which evidence a bunch of rights and assets from an underlying transaction.

One of the questions limiting development so far has been — is the SPV acting as a trustee? Does it need to be regulated as carrying on a trust business? So one of the things that we have done in the Caymans is we analyzed this over a year ago, and we have put in place legislation that carves out Sukuk from the trust business and mutual funds. So what we have done, specifically, is we have actually tried to insure that if you were to use a multi-vehicle repackaging concept, you wouldn't be engaging in the trust business by a specific act of legislation. Now, as much as I would love to say that we were incredibly innovative in all of this, we have relied upon the U.K. We looked at what the U.K. did in relation to their tax laws and saw how they combined Islamic finance with the concept of alternative instruments in, I think it was the 2007 budget, and we liked what they did. So we followed that in Cayman and we have introduced — actually, I think strictly as of today, it has not been introduced because it goes before our cabinet on Tuesday, but we expect it to be passed. And what that rule will do is put in a concept of alternative financial instrument which, when you look at the definition you will realize it's designed to cover Sukuk. I think that what this legislation does is remove a major hurdle. In terms of how the scholars will treat that, that is an open question. But I think we have done our best to kind of twist the boundaries of Islamic finance more towards Western style product.

ASR: *So could we see this as a major component of global finance?*

ROBERTSON: That is probably more a question [my partner] Jawed can answer. I think it's an interesting era because I think if you look at the Sukuk, it seems to be gaining real efficiency. Again, the market is always going to look for efficiencies in due course. And if you go back to something Rob said, I think as time develops and people get more comfortable with this type of product, you will see that it's kind of a natural progression. Certainly that's the way I feel.

WIPPERMAN: I am torn about whether Islamic finance, generally, will be accepted by the entire world and will become every bit as efficient or every bit as used as conventional finance. It seems to me that without some sort of codification, without some sort of governing body that can say yes, this works or no, this doesn't work, that it is really going to be hard to deal with the uncertainty and the lack of efficiency and standardization to have it ever be an equal type of alternative finance system. I think it will be in the areas where it is now, Malaysia and the Middle East. I know the U.K. is studying the possibility of issuing a sovereign Sukuk. I think they'll get some of that. Germany has done it, I believe. But whether it will ever truly compete with conventional finance, I'm not convinced.

MALOUF: I think this is a case in point - and I agree with you that Islamic finance will be attractive in those regions and it will continue to grow in those regions that you have mentioned. The reason that codification, in terms of Islamic finance and Shari'a principles, and in terms of other areas of law in the Middle East, is not easy, is because there is no general tendency toward codifying things in the way that we are used to seeing them, for example, in the United States and in other common law jurisdictions such as Australia, the U.K. and European countries. You have to understand many laws here covering fundamental areas such as property, commercial transactions and finance have only really come into being in the last five to 10 years. The bodies of law in countries such as the U.S., Australia and the U.K. covering these areas have been in place for hundreds of years. So this is the situation that we are dealing with. And I think, in terms of Shari'a law, because a lot of it turns on the opinions of the scholars through the issuance of fatwas, I don't think that there will be a large drive towards having that body of law and opinion codified. So I think the general Shari'a principles will still be largely based on individual opinion and healthy debate and discussion.

ARNHOLZ: If I could follow on that, Rob. Our own history in structured finance before Regulation AB, which are the U.S. SEC rules that came out relatively recently, to codify 15 years of unwritten principles.

WIPPERMAN: Yes, the rules codified the "lore" of structured finance.

ARNHOLZ: The point is that the structured finance market worked very well with merely lore.

WIPPERMAN: But this is different, because that was just — you know how to do it, you have practiced it, the lore's there. Here it's a stamp of approval — you can do it or you can't do it and you could go to four different boards and get four different answers.

ARNHOLZ: Yes. The problem brought about with different scholar views on what is and is not a compliant instrument, goes to, as I think our friends at JPMorgan would tell you, liquidity concerns. If an instrument cannot be acquired by the entire market, liquidity is reduced in that product.

HERMANN: That's one of the things that I see. When we came back from our trips and listened to people here it seems that it's not going to be a big piece of global finance. Keep in mind what we are going through here in the states right now, speaks to this issue. We are about to get into one of the biggest regulatory changes in banking, in securitization, in rating agency land that we have ever seen in our careers, despite how long we have been doing this. So unless there is an effort, whether codifying is the right word or not, or transparency is the right word, or standardization is the right word, any of those things that we have discussed, I can't see this growing to the point of acceptability, which turns into the liquidity argument and, frankly, back to efficiency. It's hard to see it really accelerating past what it is today.

The problem that we all are seeing is

Anthony Hermann ▶

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there is a staggering amount of dollars sitting there, and will that then get funneled into U.S. product, you know, pre or post regulation, U.S. style, I should say Western products is probably the right way to say it? Or will the Islamic structure grow and change and be codified? And I think, until it does, it's hard to see this market really taking off to compete or even be considered a major presence in global finance.

CLARE: We have, obviously, a parochial view here in New York. We have seen this tremendous transfer of wealth to the region, and this simple concept that perhaps assets that don't bear interest could be financed was intriguing for us. And based on the limited amount of research we have done, it seems to us that most of the activity is fueling regional growth, whether it is in real estate or other assets and more recently, in local currency type assets. And we haven't seen the interest to globalize that market yet. We are watching it carefully and we would love to see signs and we would love to be innovators in trying to make it happen, but the returns within the region seemed to be so attractive in oil and gas and real estate and other local assets that it's tough to think of them reaching beyond the region to broaden the market, at this point in time.

ARNHOLZ: Mike, one thing — and I am curious to ask the table — there has been a lot of talk about the U.S. Treasury issuing sovereign Sukuk. The idea generally would be that the government would take some asset, maybe office buildings that house the **Agriculture Department**, and transfer them into an SPV. The SPV would then issue Sukuk which would be entitled to cash flow from the underlying property — rental payments from the government. I don't know whether that will happen, but it would be a galvanizing and influential market event.

CLARE: Sure. One of the — and I would love to get Alasdair and Adam to come in — one of the other phenomena we think we recognize is that there doesn't seem to be an interest in paying up for higher quality assets yet, that the returns on projects within the region have been so attractive that if you were to bring in even a U.S. government paper, they would certainly want to finance it, but not at rates that would be comparable to treasuries.

VISSER: And to add to that, a lot of the investors seem to have mandates to invest locally as well, in the region, and not to go beyond the region, North Africa and the Gulf. That limits somewhat the ability to bring foreign issuers to the market.

CLARE: But, again, if Adam and Alasdair could comment on that it would be terrific.

ROBERTSON: I absolutely agree with that.

MALOUF: I think that a lot of the financial institutions and other investors invest in this region because the returns generated are quite attractive here. Especially, from our perspective, which is commercial property, we are seeing a lot of people coming into the region who invest because of significant yield compression in Western markets, which is particularly significant in the European and U.S. markets, which hasn't really happened here yet. You are still getting acceptable yields for property investment in the Gulf region. In this sense, I am talking about investment in income-producing existing property, which would be the less risky end of the investment spectrum. We are still seeing yields at around 8.5 to nine percent, whereas yields produced by similar assets in Europe are barely reaching 4 percent. So it is quite a unique situation. I think that's the reason why there are no substantial government bonds on issue in this part of the world because there is the impression that they may not pay the returns that people are looking for in a buoyant market.

CLARE: It's clearly been a boom market and with real estate at the core, and perhaps it's a bubble, maybe it's not, but if that bubble bursts, maybe things will change. But all the people with whom we spoke were making so much money, particularly in real estate, that they had little interest to do anything other than that.

***ASR:** Alasdair, you wanted to say?*

ROBERTSON: I would entirely agree with all that common sense. That's exactly what we would say as well. In the end, the money is in the region, and in one coined phrase we have heard many a times, liquid cash. There is so much on the supply side and the demand side that, as Adam said, the yields are there, so we wouldn't necessarily see a need for the U.S. government to come in and try to raise money. There is enough of a driver in the market in the Middle East on its own to keep the market going.

CLARE: We have also seen or heard that the recent trend is toward local currency financing and away from the dollar.

MALOUF: I think that's correct. I think that this is in response to the fact that a lot of the governments here have chosen not to touch the de facto or the official exchange rates which are in place.

HERMANN: Isn't that also a sign of the times, though? The dollar has been halved in the last two or three years, and it doesn't look like that direction is changing. The government is going to have to flood the system with dollars in order to fix the banking crisis and to fix the consumer situation right now. So it's unclear to me that, at least when we talk around the office, that any of that direction at all is going to change. And the real estate boom in Dubai and everywhere else in the region will probably continue for a while.

MALOUF: And the banks generally here lean more towards local currency issues, because, one, it's just easier for them; and two, it is becoming increasingly more difficult and more expensive to put in place appropriate hedging or swap arrangements to minimize any fluctuation in currencies. We did a commercial mortgage-backed securitization in July 2007, which was the first and still remains the only rated CMBS for the region, given the state of the market since that time. We put in place proper swap arrangements, but we were doing this at a time when it was still economically feasible. Now I am not so sure, and even at that time the market for U.S. Dollar/Dirham swaps was quite small.

CLARE: One of the needs for financial products that we clearly did see when we were there was the need to develop short-term liquidity in the market. We haven't quite figured out how to do that, but I think the only exception to what we have said about external product might be if it had a great deal of short term liquidity attached to it.

ARNHOLZ: Sukuk typically have three, five or ten year terms. I don't think there is anything with a shorter life than three years. There is no compliant money market product right now.

CLARE: I think that's the reality. All the banks with whom we have spoken said there is a crying demand for short liquidity.

MALOUF: Definitely. There aren't those types of products generally. Like you said, the minimum period is not even five years. There are a few three-year products on issue. At least five years is the norm, if not more, some up to 15 years.

ARNHOLZ: Adam, do you agree that there would be substantial appetite for the shorter maturities?

MALOUF: I think there would be. If you are looking at the investor base being GCC companies or GCC nationals, their investment horizon is, generally, but not always, substantially shorter than that of Western investors. They look at a three-to five-year maximum investment horizon. Anything more than that, and generally, but not always, they are not interested, purely because the gains are there to be made, and they are there to be made quickly.

VISSER: It is also a reflection of a lack of insurance companies as investment managers. Here insurance companies provide the investor base for the long end of the curve.

MALOUF: That's correct, and this doesn't exist in the form that it would exist in the United States, for example.

ASR: *So, in terms of Sukuk, can we talk about exactly what they are and who is issuing them and why would non-Muslim countries issue Sukuk? We brought up the U.S. considering such a product or a finance vehicle.*

Michael Clare

We have also seen or heard that the recent trend is toward local currency financing and away from the dollar.

ARNHOLZ: Sure. Sukuk are Islamic bonds that resemble, in many respects, a conventional Western securitization. They have had spectacular growth over the past couple of years. Current outstanding Sukuk are approaching $90 billion which is expected to increase to $150 billion by 2010 by some estimates. Sukuk offerings are typically oversubscribed by three times. As a legal/technical matter, they represent the holder's proportionate ownership interest in an underlying asset and it must be a real asset, not just a financial interest or financial asset.

CLARE: What sort of assets? Is it primarily real estate, oil and gas? If you could dig down to those facts, what would we see?

ROBERTSON: I think what we see, from the commercial perspective, would be predominantly real estate. Adam, I believe you would agree with that, wouldn't you?

MALOUF: Yes, it is predominantly real estate. You are seeing issuances of Sukuk coming from government-related entities in the region. But it is predominantly real estate I would say, commercial, residential and leisure-related real estate, and, to a lesser extent, industrial real estate.

ARNHOLZ: The prototype structure would be the obligor would sell an asset to the SPV, and then the asset would generate a return.

WIPPERMAN: You know it's become a popular form of finance when there is a web site called www.sukuk.net. So you know you have kind of hit the big time. But I think part of the reason for that popularity is it actually is quite flexible. You can do an awful lot of different things or you can work around a lot of different prohibitions within Shari'a and accomplish your financial goal. They are listed, they are traded, they are rated, they are probably as close to conventional Western financial instruments as Islamic finance can produce.

CLARE: Maybe you could walk us through how the risk sharing concept works there.

WIPPERMAN: Well, Alasdair, maybe you want to jump in if I misspeak. But usually there is an underlying Shari'a compliant transaction, such as a lease, where the risk is shared.

CLARE: But it's not shared with the ultimate investor?

ROBERTSON: It's shared through the SPV.

CLARE: If there is a shortfall?

WIPPERMAN: Then there is a shortfall. There is no guarantee of return of principal. There is no guarantee of your profit rate, in theory.

ROBERTSON: I agree with that. That is correct. I mean, on the asset side, you have got to remember most Sukuk, or what we use in so-called partnership structures through Shari'a, have the SPV as one of the "partners" that provides the cash. The originator of the deal is the other "partner" and brings in the asset, and they share the profit generated by the asset, be it real estate, leases or Shari'a-backed loans, whatever it is. And that Shari'a agreement specifies who gets what. One interesting element is in terms of the recourse nature, you don't have to worry about it as much because of the trust certificate. The SPV says to the investors, "you have got a beneficial undivided interest in the property which we are holding, or the right of the SPV in our partnership, and you will be given returns on a pro rata basis generated by this partnership." So that's how it passes through. This is the way it was traditionally being done. It is also fair to say that the more recent Sukuk have used the lease structure more than the partnership structure. The so-called Ijarah concept, which is effectively what I think we call a leaseback, where the originator leases the asset to the transaction, the asset then generates returns, it is split off and then at the end of that transaction, at the lease end the asset goes to the originator. So those are the two types on the asset side that we see accomplishing the lease end.

ARNHOLZ: And it's probably worth pointing out in the Ijarah and other more recent Sukuk transactions, there has been a lot of controversy as to whether or not the transactions are really compatible with fundamental Islamic principles of finance. The formula return on some of these deals looks to some a lot like interest, and sometimes it's harder to find the true underlying economic activity. There is a very well known paper delivered by the AAOIFI last year called "Contemporary Applications of Sukuk," which called into question whether or not

◀ *Johan Visser*

From an investor perspective, since these markets are just starting off, they are in the baby steps, there is a lot of reliance on, or a large portion of the investor base is, Western style investors.

some of these obligations were, in fact, compliant. The more you see innovation in the market, the more pressure you are going to see brought to bear on traditional structures.

CLARE: Alasdair, have you seen any structures where an originator would bring an asset to an SPV and sell his economic interest and the SPV would have the rights to the residual value? Or does that need to stay with the originator?

ROBERTSON: In relation to certain restrictions, no. Obviously you get something where you can get what Adam is saying on his side of finances. You can have an investment fund in the normal course, but not on the Sukuk side.

ASR: What are you seeing?

MALOUF: To finish up on a point that John made, and to go back to something Rob said, that is entirely correct: AAOIFI did put out that pronouncement in the last year or so, I believe, relating to some of the early Shari'a structures. I think this is going to be the role that AAOIFI plays in the marketplace in this regard. What the market needs is certainty and AAOIFI's pronouncements are going to be critical and integral in giving investors and institutions comfort that the structures proposed do work and will work going forward. However, I agree that achieving comprehensive codification is going to be difficult.

VISSER: I think one of the other aspects that we haven't really touched on in the Sukuk is ultimately full recourse back or expectation from creditors and investors to have the full recourse back to the issuer. That expectation, together with the lack of depth of the market and the infancy that we have talked about, will make it difficult to transfer or bring new asset types to the market on a non-recourse basis as we would see, for example, in the securitization market in the U.S.

ASR: Cristal, what are you seeing from your perspective?

JONES: I can only speak from the U.S. area as I know outside of the U.S., there has been a lot more activity, but S&P did rate its first U.S. securitization that was a Sukuk in 2006. The asset was an oil and gas volume production payment transaction with ABS analytics that included a review of the originator, legal and economic aspects, the assets, etc., but it was a true securitization in that it was not Originator guaranteed and was rated higher than the Originator's credit quality, and in this case, 'CCC+'. And again, though this was a Sukuk, S&P does not opine upon or pronounce on the suitability of a particular obligation from the perspective of Shari'a compliance. We understand its basis, but it has not featured in S&P's ratings analysis. I haven't received a lot of ratings inquiries in this area, but would welcome it.

ARNHOLZ: But, I mean, you rate Shari'a instruments the same way you rate conventional instruments, you look at the likelihood of payment.

JONES: Sure.

ARNHOLZ: In other words, the economic and the structural aspects of the deal, but you pass on whether or not it is compliant under Shari'a. That's for the scholars, I guess?

JONES: Absolutely. I mean, we note that the transaction satisfies the conventional credit and commercial law aspects of a deal which are really the basis for S&P's ratings opinion, but we wouldn't opine upon Shari'a compliance. To my knowledge, all of S&P's rated Sukuk have met the approval of a Shari'a board.

MALOUF: One other thing, just to go back to the non-recourse point. One of the interesting things is that you don't have to worry about the "lack" of recourse. You are actually somewhat, from an investment perspective, in a better situation because you are a beneficial holder in a trust, and the usual fiduciary duties of the trustee are applied in these structures. It is slightly weird, and it's a by-product of why investors invest in a trust, when, in fact, from an investment perspective, it means that the SPV and the trustee are bound to do what it can to insure that the return is passed through to the investor. So, on a non-recourse point, I think it's economically the same as non-recourse loan.

CLARE: Have we seen any Sukuk default?

WIPPERMAN: Well, how do you define "default" when it is an equity type of investment?

Adam Malouf

Shari'a is, basically, especially in the Middle East, an all-encompassing way of life. It governs everything that is done in many countries in the Middle East.

HERMANN: Disappointment, maybe.

ASR: So what types of collateral have you seen in the transactions?

JONES: For oil and gas, specifically for the Sukuk, it would be similar to other oil and gas transactions, where you are looking at the types of asset reserves, the production coverage, etc.

ASR: *So are we seeing anything in the way of true consumer finance receivables being bundled?*

JONES: From the U.S. ratings perspective, not that I'm aware of.

ARNHOLZ: We have discussed whether a residential mortgage Sukuk could be developed — something like MBS. I don't see why not. You would have an SPV that would actually hold title to the residences. The underlying mortgages would look very similar economically to current U.S. residential style mortgages but the properties would be leased to the "homeowner." Actual ownership would not be with the homeowner but would be held by the SPV. The SPV would then hold the leases and title to the properties. In all Sukuk, the key is that an income-producing asset is required, for example, airplanes. Similarly, a carrier that owns airplanes could convey the airplanes into an SPV and then lease them back. The SPV would then issue Sukuk, as to which the airline would be the obligor, and lease payments would flow through at some rate.

MALOUF: And that's what they have just done, as I mentioned earlier in our discussion, in Abu Dhabi. Sorouh is one of the master developers in Abu Dhabi, along with Aldar. What they have done is they have issued a Sukuk, but it is a combination of a Sukuk and a receivables securitization. Your cash flow, essentially, is the installment payments from all of the purchases of all the off-plan properties that they are developing. These are their installment payments under the sale and purchase agreement. That's basically your cash flow. And, on that basis, they have issued the Sukuk into the market.

ASR: *I only asked the question about collateral because if you look at the history of the mortgage market, it started out with residential mortgages, and then it expanded into cars, auto loans and student loans, and commercial real estate came as a secondary item. So it's kind of interesting to see where this goes now. Do you see auto loans or maybe credit cards? And one market we haven't touched on was Indonesia, which has the largest Muslim population in the world. So you have to ask the credit card industry, could it take off there and securitize receivables or even residential mortgage paper?*

ARNHOLZ: I think there would be some difficulty in dropping a credit card receivable into a Sukuk.

WIPPERMAN: That's kind of classic money-on-money.

CLARE: Auto leases might be more palatable.

WIPPERMAN: I would think auto leases would be the best type of asset class that we are used to over here for manipulating into an Islamic finance type approach. One of the things we struggled with was the fact that you actually had to get title to the vehicles in the trust. So we came up with titling trusts and all that good stuff. And so the technology exists. Unfortunately, it appears the product of auto leases is no longer going to be with us.

ARNHOLZ: Rob, didn't one of the larger Dubai mortgage companies or development companies complete a securitization?

WIPPERMAN: Tamweel.

MALOUF: Tamweel, yes.

Alasdair Robertson

A lot of the similarities are, obviously, that once you get past the idea of the fundamental principles of Islamic finance ... I think you are on the path to match Western style to Islamic finance.

WIPPERMAN: From my perspective, it looked to be a Shari'a compliant securitization. The underlying mortgage loans were leases. The notes were issued in a private placement into the European market. Is that your understanding, Adam?

MALOUF: That's correct. For all intents and purposes, the Tamweel transaction was a Shari'a compliant securitization and it was actually tranched as well. That's one of the issues in terms of whether or not an Islamic securitization has actually been achieved in the market. Tamweel has said that it is an Islamic securitization. It is an ongoing debate, but it was probably the closest that we have got to that type of transaction.

WIPPERMAN: I understand after that transaction, as you said, that some scholars were questioning the tranching.

MALOUF: Yes, that is correct, they were questioning it, and they are still questioning it. The debate will continue, and, as I was saying before, one of the things about Shari'a law and jurisprudence is that you will always have a difference of opinion.

WIPPERMAN: Right. At the end of the day, it is not even that your board says it is okay, but the investors, they look to their own scholars to decide whether they are happy with it. So, the fact that one set of scholars blessed it doesn't necessarily mean that even the investors are going to go along with that.

***ASR:** So when we look to the future of the market, what do we have to see in terms of a development to kind of speed up the growth of this market? If you were to put a grocery list together, what do we need?*

WIPPERMAN: I think there is agreement, and maybe it is a function of having too many lawyers involved here, but, clearly, some sort of codification or binding precedent or collection of opinions would be most helpful. A lot of the Fatawa are not even published, so you can't even find out what some people thought about it. So that, to me, seems to be the biggest hurdle, but, again, I am willing to accept that it could just be the Western bias here.

HERMANN: I would agree. I think if you look at what happened in Western finance, particularly in states in the past 18 months, with all the standardization we have, with all the regulation we have, with all the accounting bodies we have, we still ran into a problem. And it's hard for me to see this really taking off without any kind of government, any kind of governing centralization, standardization, pick whatever word you want, it's tough for us, at least as a U.S. banker in securitization, to see this taking off the way the Western model did.

CLARE: We are beginning to see some signs that they are looking beyond the region as a lot of these wealth funds we have, the government wealth funds, like [Mubabala], are beginning to look beyond the region for strategic investment. That is a pretty helpful sign that there is some transfer of wealth outside the region, some effort to look beyond oil and gas and real estate in the region. Hopefully, if there is more of that, that will begin to allow for a flow back into the region of foreign assets.

ARNHOLZ: I'll be the outlier. I don't think you need codification. It would be nice to see some more consensus from the scholars. I think, for me, the bigger issue would be the development of a real Islamic money market type structure.

CLARE: I agree with you, John. Every bank, again, with whom we spoke said there is a real need for a shorter liquid product. There is a lot of liquidity backing up in the banks, and they have nothing they can do with it to keep it Shari'a compliant.

***ASR:** Adam, what do you think?*

MALOUF: Well, I am a lawyer by background, I am Western trained, and I have been here long enough to see that it does help to have some sort of framework or structure in place. And I think that, in terms of the body of jurisprudence which comprises Shari'a, there will be a move toward codifying that in some form. It may not be codified in the way that we expect it, but there will be, I believe, a move toward some type of general consensus. It will move a lot more slowly than Western nations. That's the nature of the way things operate here. And that's largely a cultural matter as well, and that's something that won't change overnight. But I agree that, also, it is not so much a legal matter, it is also a commercial matter. There needs to be established Islamic money markets. We need to see more acceptance of Islamic finance as a viable method of raising funds. I think also we need to have an understanding why Islamic finance is structured the way it is, how it can benefit from an origination perspective in terms of raising funds.

I think it will be confined to particular markets naturally, but we have seen a rapid growth in Islamic finance in those particular markets. And, obviously, where there are large pockets of population and companies who are of the Islamic faith, there will be a great deal of growth. I think in places like Indonesia, there will be significant growth there, as well as in the U.K., where we have seen the establishment of the Islamic Bank of Britain, and a plethora of Islamic financial institutions being established here. But, all in all, I believe that, when there is a move towards consensus, as well as a wider awareness of the benefits of the Islamic finance, you will see substantial growth in this market, even more than what's happened up until now.

***ASR:** Alasdair?*

ROBERTSON: I agree with everything. The only thing to add is, I think, the role of ratings, which would be asked of Cristal.

***ASR:** Cristal, your kind of outlook, what has to happen for things to take off?*

JONES: From a ratings standpoint, we are really indifferent. We haven't, as I said, received a lot of inquiries related to Islamic finance, but if we were to be presented with a transaction similar to what we have already become comfortable with in the past, the entire analytical package, then, for us, we would be interested in the opportunity to look at it again.

ROBERTSON: I just think, to go back to your point, I think consistency is key, and I think their role in providing that consistency can be very, very critical. ASR