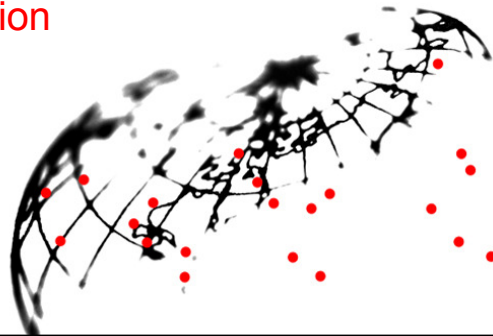


ICG London *Sukuk* Summit  
The Royal Horse Guards

Risk Management considerations in *Sukuk*  
Issuance & Securitisation

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## This time last year

- A year is a long time in Islamic finance:
  - A well attended conference and exciting developments
  - Interesting transactions closing (e.g. Tamweel (Securitisation); Bahrain Government Sukuk (LSE listing) etc.)
  - December 2007 – Sheikh Taqi Usmani paper (Sukuk and their Contemporary Applications)
  - Various AAOIFI meetings and pronouncements
- Uncertainty about the correct treatment of transactions – past and future
  - Relevance of sub prime crisis
  - UK situation – HM Treasury and FSA?

## What are risk factors?

- And why are risk factors needed?
  - In layman's terms risk factors are statements inserted into offer documents for financial instruments to warn the creditor about risks inherent in the investment
  - Alternative finance bond has to be listed on a recognised stock exchange (Finance Act 2007)
  - The legal requirement to set out the 'risk factors' in an offer document comes from securities legislation (e.g. in the UK the FSA Prospectus Rules, Chapter 2.2 describes the format of a prospectus, Articles 26.1 (3) specifies the risk factors must be a distinct part)

## Risk factors peculiar to *Sukuk*

- Complexity
  - *Sukuk* tend to be document intensive and relatively complex compared to conventional bonds – because of the underlying asset structure
- Emerging market risk
  - *Sukuk* involve a complex relationship between Shariah and local (very often secular) legal systems – the scope for conflict is great
- Regulatory treatment
  - the Islamic analysis of investor relations may be different from the traditional analysis of bondholders – collective investors versus holders of debt -see later

## The Shariah compliance risk

- There can be no assurance that any particular *Sukuk* issue is Shariah compliant although a fatwa is usually obtained
- None of the Issuer, Originator or Lead Manager makes any representation that the issue is Shariah compliant
- Differences of opinion are possible and investors should obtain their own Shariah advice
- What are the implications of a *Sukuk* issue not being Shariah compliant?
  - Not fully worked out
  - Can transactions be re-opened? Who has *locus standi*?
  - Can profits be retained?
  - Reputational repercussions for (a) lead arrangers and (b) the industry as a whole

## Risks arising from the structure of a *Sukuk* (1)

- Issuer as Trustee
  - The Issuer also acts as a trustee, holding its assets for the benefit of the *Sukuk*holders, creating a potential conflict in its roles
  - Certain functions (e.g., enforcing the Purchase Undertaking) are therefore delegated to an independent third party (typically a professional trustee company) called the Delegate.
- *Valuation*
  - On some *Sukuk*, the assets underlying the *Sukuk* are not independently valued (e.g. PCFC, Dubai Civil Aviation Authority), requiring a risk factor informing investors
  - Increasingly, the assets are independently valued (e.g. Tamweel securitisation & the Chelsea Barracks (NB: latter was not a *Sukuk* deal)).
  - The risk factor will then say that the valuation is accurate at the time it was obtained and either will not be updated or will only be updated periodically

## Risks arising from the structure of a *Sukuk* (2)

- Assets
  - Assets are crucial to *Sukuk* – AAOIFI has reiterated this
  - There should always be risk factors appropriate to the assets
  - Many assets in jurisdictions like the Gulf have a short operating history (e.g. property valuations, credit card receivables and have not been tested in adverse market conditions)
  - The risk factors will need to disclose the likely effect of a market downturn on the *Sukuk* assets

## Risks relating to enforcement

- **Bankruptcy Law**
  - The bankruptcy law of the “originator” may adversely affect its ability to perform its obligations under the Purchase Undertaking upon its insolvency. There may be little precedent for dealing with the claims of capital markets investors in a local law insolvency (e.g. in UAE)
- **Enforcement of Liabilities**
  - Payments under the certificates are dependent on the “originator” making payments to the Issuer/Trustee, pursuant to the underlying local law transaction documents, including the Purchase Undertaking. If the originator fails to do so, the investors may need to bring a claim against it in the local courts, which will be costly and time consuming
- **Enforcing judgments in local courts**
  - Local courts may not enforce an English law judgment without re-examining the merits of the claim and may not recognise English law as the law of the contracts, or only to the extent that it is not incompatible with local law and public policy
  - This would mean that the local courts could seek to reinterpret English law governed documents as if they were governed by local law. They could therefore give effect to the documents in a manner not intended by the parties.

## And the usual risks also need to be covered

- Political, economic and related considerations
  - Political stability - “T” word
  - Continued economic growth
  - Changes in local law which could impact the Originator/Issuer’s assets, financial condition, results of operation or prospects
- No secondary market
  - This is a standard risk factor but it is usual for many *Sukuk*holders to be “buy and hold” investors
  - Limited trading in the secondary markets for *Sukuk* means limited liquidity

## Regulatory treatment

Are *Sukuk* collective investment schemes?

The AAOIFI definition of *Sukuk*

*“Investment Sukuk are certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity” \**

\*Definition: paragraph 2 of page 307 of Shariah Standards for Financial Institutions 2008, published by Accounting and Auditing Organisation for Islamic Financial Institutions

## Collective Investment Schemes (CIS)

- Section 235 of FSMA defines CIS as a wide range of arrangements that provide for the collective investment of investor contributions

The definition says the arrangements must be such that the participants do not have day-to-day control over the management of the property and the arrangements must have one or both of the following characteristics:

- the contributions of the participants and the profits or income out of which the payments are to be made are pooled; and
- the property is managed as a whole by or on behalf of the operator of the scheme.

## FSMA

- The FSA review (based on *Mudaraba* structure) treats *Sukuk* as unregulated CIS and for the purposes of listing as a debt instrument.
- If a *Sukuk* is a CIS, then:
  - The promotion of *Sukuk* is subject to certain restrictions under FSMA because the CIS is unregulated
  - The person operating the CIS in or from the UK will need to be authorised under FSMA (not relevant if the *Sukuk* issuer is based outside the UK)
  - If a *Sukuk* is not a bond then stabilisation is not permissible - market abuse - although the stabilisation legend is usually included in the offering circular and the subscription agreement
  - Grey market trading - not permitted under the Shariah (cannot trade what does not exist)

## Is there an alternative analysis?

- FSA is also considering if *Sukuk* should be treated as a debt security under Article 77 of the Regulated Activities Order
- Article 77 of the Regulated Activities Order defines instruments creating or acknowledging indebtedness as debentures, debenture stock, loan stock, bonds, certificates of deposit or any other instrument creating or acknowledging indebtedness

## Listing

- Classification of *Sukuk* as CIS under FSMA is not conclusive as to how *Sukuk* should be classified for listing purposes:
  - UKLA treats *Sukuk* as ordinary debt securities, subject to providing additional information as required
  - First *Sukuk* listed on UKLA was Tabreed (2006)
  - It was possible for UKLA to treat *Sukuk* as “asset-backed” security but this would detract from the role of the originator
  - Not treated as a CIS because the purpose of a *Sukuk* may be to finance a single project rather than a range of investments

## Some closing remarks

- Watch this space
  - The status of *Sukuk* in the UK as CIS / debt instruments is still under discussion with market participants
  - The FSA may decide to treat *Sukuk* as debt instruments in the future rather than as CIS because they are economically equivalent to debt securities
  - It is likely that *Sukuk* will be defined by reference to section 48A of the Finance Act 2005
- Will this treatment hold for all purposes?
  - *Sukuk* are an evolving asset class
  - Regulators may need to be more adaptable in the future

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