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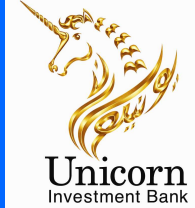
Unicorn Investment Bank, B.S.C. (c)

Prospects for Takaful Cover and Securitizations

**Islamic Real Estate Finance Middle East 2005
17- 19 December
Grand Hyatt Hotel, Dubai**

By Dr. Omar Clark Fisher – Ph.D.
Takaful Business Development





Agenda

- Overview of Takaful (Islamic Insurance)
- Overview of ABS
- Dissecting the Risks in Securitization
- Takaful Offerings and Responses
- Prospects for Takaful Cover and Future Securitizations
- Observations and Conclusions

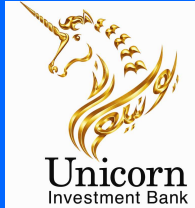


Overview of Takaful (Islamic Insurance)



What is Takaful (Islamic Insurance)?

- A system of Cooperative Risk-sharing for Indemnification and Mutual Protection (however cooperative alone is not sufficient to be a Takaful operation)
 - Clear segregation of interests exists between Policyholder and Operator
 - Compliant Investment Strategies (i.e. no investments in stocks issued by companies dealing with alcohol, pork, gambling, or exceeding certain debt ratios, etc.)
 - No Investments in interest-bearing instruments or derivatives
 - Under ILI Conventional Risk Premiums are replaced by Charitable Donations
- *Although the “Job” is the Same, the Intention (Nea’a), the end Purpose, the Contract and the Operation of the Risk-sharing Mechanism are different.....*
- ▶ Also, Adherence to these Principles is constantly monitored by a Sharia Advisory Board



A Comparison -- Core Differences of Islamic Life Insurance with Conventional Insurance

Topic	Commercial/Stock	Mutual	Islamic Insurance (Takaful)
Organization Principle	Profit for shareholders/ Risk transfer	Mutual for Policyholders	Mutual for Policyholders
Value Proposition	Profits for Shareholders	Affordability to Policyholders	Affordability, [Spiritual Satisfaction and profit for the Operator]
Laws	Secular/Regulations	Secular/ Regulations	[Sharia] plus regulations
Capital	Shareholders	Initial Premiums	[Operator provides set-up capital]. No paid up capital for Takaful fund
Ownership	Shareholders	Policyholders	Policyholders yet Operator owns Management Company
Management	Company Management	Appointed Management	Operator
Contract Form	Comm. Exchange/ contract of compensation-adhesion	Mutual risk-sharing with aspects of comm. contractual principles	Cooperative, [Islamic contracts of Wakala or Mudarabah with Tabar'ru donations]
Investments	Equity/debt-no restrictions	Equity/debt-no restrictions	[Sharia compliant equities and interest free investments]
Surplus	Shareholders account	Policyholders account	Policyholders' account- [may be Performance fee for Operator]

[Differences] shown between Takaful and Mutual Insurance



Overview of ABS

- Asset-Backed Securities (ABS) has mushroomed into a gigantic market of primary and secondary financial transactions - \$455 Billion in USA only for Yr. 2004 ¹.
- Classifications:
 - Consumer Receivables– Auto Loans, Auto Leases, Home Equity Loans, Credit Card Receivables
 - Mortgage-backed Securities– Residential Home Loans/Leases, Commercial Real Estate mortgages
 - Commercial and Industrial Loans– CDOs
 - Receivables from Equipment and Computer Leases, Aircraft, Shipping, Cargo Containers
 - Structured Financings- CLOs, CBOs, CMOs
- First F/G in 1971 for municipal bonds.
- Cash only transactions until late 1990s when “synthetic financings” were introduced using credit derivatives.

**1 Source: BancOne Capital Markets
Report- ABS Yearbook Jan. 2004**



Islamic Perspective for ABS

- Transaction must be Asset-based, generally tangible property subject to ownership
- Transaction must not involve any elements prohibited in Sharia (such as Riba-Interest or guaranteed principal)
- Transaction must be productive investment and purposeful in adding value rather than speculative

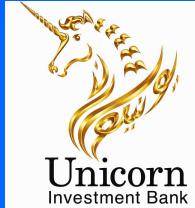


Definition of Insurance Guarantee

- “The Insurance Guarantee is irrevocable and unconditional and results in the guarantor stepping into the shoes of the issuer in that it guarantees payments in accordance with the original transaction schedule on a timely basis. The Financial Guarantor (F/G) pays the timely interest and/or principal consistent with the terms of the underlying asset financing instruments.”

Source: “Monoline Insurance and Financial Guaranty Reserving”, James P. McNichols, 2002.

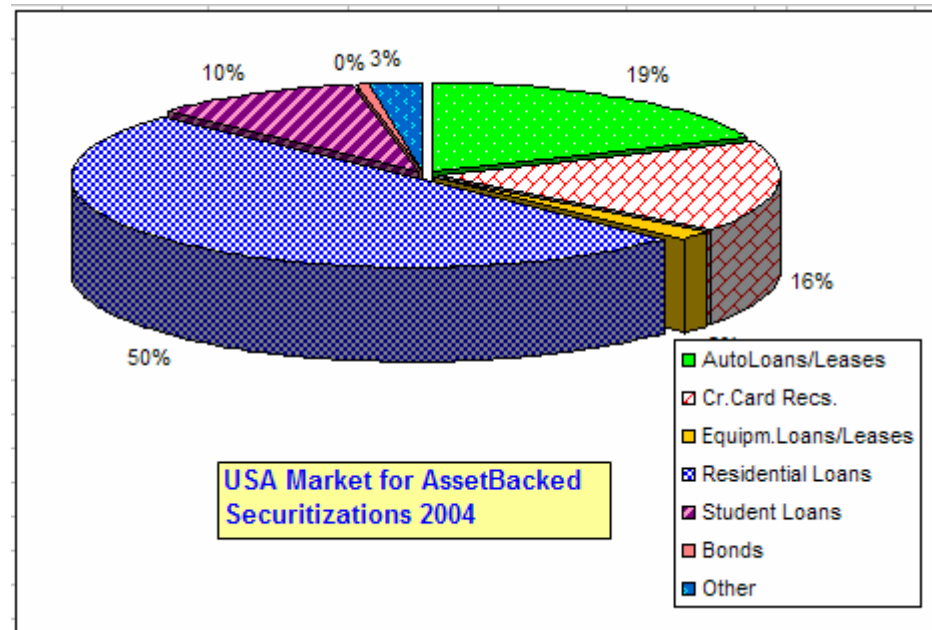
- **Islamic perspective: Financial guarantee or collateral may be employed in commercial transaction where no premium is exchanged for that pledge, yet only asset-backed, interest-free transactions are permissible.**



Size of USA Market for Securitizations – Yr 2004

- Robust annualized growth of 10% for market in securitizations overall
- Half of securitizations were Residential Loans

	Growth Rate	Bils	
		2004	2003
AutoLoans/Leases	9.0%	85	78
Cr.Card Recs.	17.2%	75	64
Equipm.Loans/Leases	0.0%	8	8
Residential Loans	6.0%	228	215
Student Loans	21.6%	45	37
Bonds	100.0%	2	1
Other	0.0%	12	12
	9.6%	455	415





Dissecting the Risks in Securitizations



What Risks Confront a Securitization of Assets?

- **Level One** – Primary base of Assets and all attendant risks to damage, loss or disappearance
- Question: How to safeguard the asset and its usufruct?
- **Level Two** – Secondary level of Securitization with associated risks to cash flow, projected performance returns and credit rating of underlying security
- Question: How to sustain expected cash flows and the initial credit rating of security?



Asset-Backed Securitization - Key Elements & Major Risks

**#4: Need for over-collateralization;
FX non-availability and political
risks; to perfect title to Assets**



**#1: Avoid impairment to Asset
Quality due to damage, loss**

**#1: Minimize loss of Asset value –
obsolescence or residual risk**

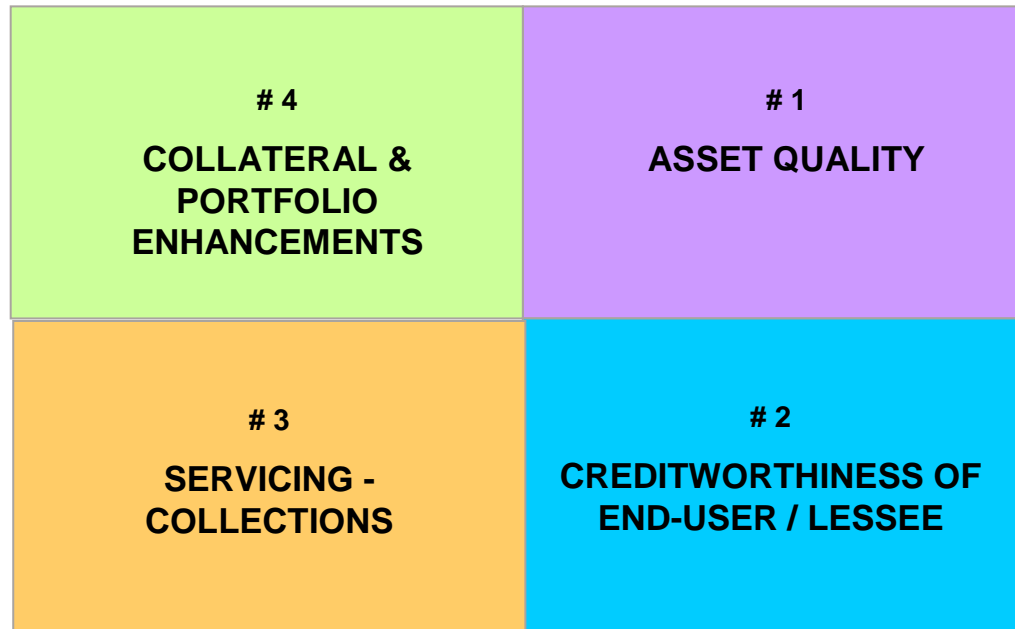
**#2: Avoid default due to death,
disability or unemployment causing
loss of income**

**#3: Avoid default due to poor
collections or dissolution of servicer**



Asset-Backed Securitization – Responses and Risk Mitigation using Conventional Insurance

#4: MonoLine – Cash Flow Guaranty Coverage



#1: Property/Casualty/Liability Coverage

#1: Residual Risk Coverage

#1: Environmental Risk Coverage

#2: Credit Life – P&I Coverage

#3: No Coverage



Takaful Responses



Comparison of Availability of Takaful Offerings

Conventional Insurance Offerings

- Property – Casualty – Liability Coverage on real property
- Residual Risk Insurance
- Environmental Insurance
- Credit Life Coverage
- MonoLine and Guaranty of Cash Flow Coverage
- Title Insurance
- T&S Coverage on Cross-border transactions

Takaful Offerings

- Yes – General Takaful
- Not Available Yet
- Not Available Yet
- Yes – Group Takaful
- Not Available Yet
- Not Available Yet
- Not Available Yet

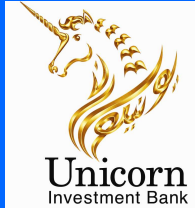


Specific Takaful (Islamic Insurance) Issues

- Absence of Ratings for Takaful Operators (exception is BEST RE – Tunisia with triple B rating) may inhibit involvement as MonoLine insurer and weaken credibility of Takaful as guarantor.
- Lack of Capacity in Re-Takaful markets – forces utilization of conventional Re-Insurance permissible under the principle of Daruraa (necessity) on exceptional basis. Yet Islamic scholars are reluctant to continually allow such “exceptions”.
- In absence of developing specific Takaful coverages that substitute for conventional coverage and respond to risk exposures in asset securitizations, then these securities packages will contain non-compliant elements which diminish their market appeal to Islamic investors. Further, such non-confirming elements may prevent an Islamic Credit Rating.
- Prohibition under Sharia to charge and accept fees/income for a financial guarantee – what might substitute for MonoLine insurance coverage (securitization wrapper)?

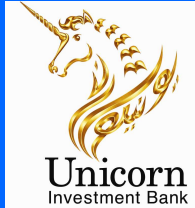


Prospects for Takaful Cover and Securitizations



What are the Important Issues for MonoLine Insurer?

- Veto Rights – ability to veto selection of replacement assets by portfolio manager if performance proves unsatisfactory
 - Liquidity Risks not accepted – born by third-parties to transaction
 - Right to replace asset manager – upon breach of performance triggers MonoLine insurer can exercise this right to preserve credit rating for transaction
 - Consent to any changes in financing structure – any change to parameters of transaction must be agreeable to MonoLine insurer
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- ***Takaful Operators would have similar rights.***

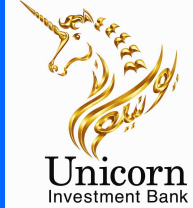


What are the Major Benefits of MonoLine Insurers to Investors and Sponsors of Securitizations?

- **Easier Execution of Securitization** – wrapped transactions pose a “double default” scenario whereby both events must occur to ruin performance: (a) default of underlying asset-cashflow and (b) default of the MonoLine supplying the financial guarantee
- **Greater Rating Stability** – wrapped transactions are virtually “downgrade proof” ; whereas Moody’s downgraded ratings of some 90 US and emerging markets CDOs in 2002.
- **Enhanced Equity Returns** – insured transactions command better economic pricings that can offset the premium cost of coverage; the resultant positive spread can enhance yields to equity investors.
- **Improved Structure and Documentation** – each transaction must satisfy the stringent underwriting criteria of MonoLine insurers which involves cash flow analysis, legal review of all documents and assessment of the overall financing structure.
- **Cohesion** – often a MonoLine insurer acts as a single controlling party so that if a transaction needs re-structuring or amendments, then as a dominant guarantor party it must consent to such changes which is simpler than negotiating with multiple investors and varying voting rights.



Illustration of Demand from one Emerging Market – Saudi Arabia



Saudi Arabia Real Estate Baseline Statistics ² – Yr 2004

- Overall Size of Real Estate Purchases is Sr 127 Billion (\$33.8)
- New Properties Purchased = 293,000 of which Housing Units were 169,000
- RE Finance Market (new Purchases) is SR 19 Billion (\$5.1)
- Unicorn estimates that Islamic financings annually are about 21% share, or SR 4.0 Billion (USD \$1.06 Bil)

- Hence, potential pool for ABS – Mortgages/Leases could be 106,000 homes within 3 Years, or a total of SR 12 Billion (USD \$3.2 Bil) available for future securitization.

2. Source: JHC Consulting Study Spring 2004 and UIB estimates.

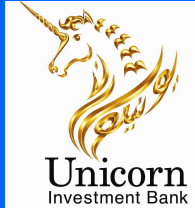


Conclusions and Observations



Summary of Conclusions

- The market for ABS in Emerging Markets (such as Saudi Arabia and UAE) is highly attractive and offers substantial growth potential
- Takaful Operators are relatively new in business and some seem slow to innovate
- A focused strategy of integrating Structured Financing / ABS and Takaful Insurance could create substantial profit opportunities and synergy for both business lines
- Developmental work is required to replace MonoLine insurance with Takaful coverage(s) yet the rewards would be manifold for Issuers and Investors alike



Observations on Value Creation by Unicorn Investment Bank....

- **UIB Identifies and exploits “niche” areas in Takaful Insurance arena–**
 - **Focus on Life – Savings segments to Individuals**
 - **Group pension schemes**
 - **Commercial/ General Takaful coverage for residential properties**
 - **Credit Life coverage to complement Islamic mortgage financings**
- **Innovative Takaful coverages are under development for UIB clients to assure comprehensive Sharia compliant financing structures (SC/FS)**
- **UIB delivers Asset and Treasury management services to Takaful and Re-Takaful Operators – including customized securities (soukuks, MBS, and special income funds) and portfolio instruments**



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Thank You for Your Attention!

**By Dr. Omar Clark Fisher – Ph.D.
Takaful Business Development**

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