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## Shari'ah, Sukuk and Credit Risk: A Moody's Primer

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Shari'ah encourages investment in specific and tangible investments.

Sukuk, sometimes known as Islamic bonds, satisfy this need and, are better described as 'trust certificates' or 'participation securities' that grant the investor a share of an asset along with the cash flows and risk commensurate with such ownership.

While such a description may be consistent with conventional asset-backed securities (ABS), this article shows that currently, the underlying credit risk of such investments can have more in common with conventional unsecured lending.

### Shari'ah principles and financing

Within Shari'ah, there are many principles that relate to finance and trade. The majority of them originate from the:

Qur'an, the first source of Islamic jurisprudence

Sunnah, the way of the Prophet Mohammed (PBOH)

Hadith, the narrative records of the Prophet's (PBOH) life, actions, and sayings

Some key principles that are most relevant to our understanding of Sukuk follow below:

### The importance of assets

Shari'ah requires that financing should only be raised for trading in, or construction of, specific and identifiable assets. Trading in 'indebtedness' is prohibited and so the issuance of conventional bonds, which usually represent interest-based funding for non-specific general corporate purposes (which could subsequently be traded), would not be compliant. A non-interest bearing loan however, could be traded if priced at par value.

Thus, all sukuk returns and cash flows should be linked to assets purchased or (in the case of project finance) those generated from an asset once constructed and not simply be income that is interest-based.

This requirement for 'tangibility' has consequential effects in other areas, such as derivatives.

### Prohibition of interest or "Riba"

As Shari'ah considers money to be a measuring tool for value and not an "asset" in itself, it requires that one should not be able to receive income from money (or anything that has the genus of money) alone.

This generation of money from money (simplistically interest) is "Riba", and is forbidden. The implication for Islamic financial institutions and securitisations is that the trading/selling of debts or receivables for anything other than par is not permissible.

### Prohibition of uncertainty or "Gharar"

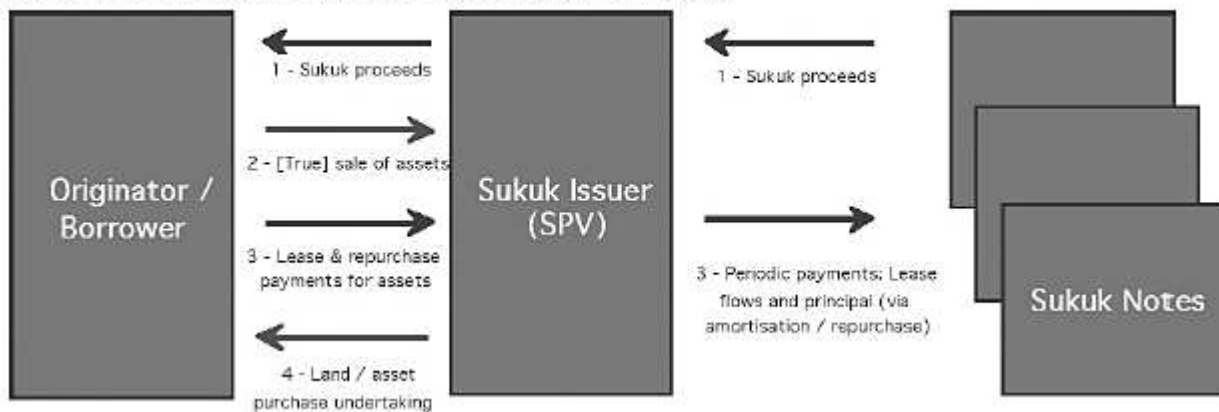
This principle and its consequences for sukuk is currently among the most studied in the context of Islamic finance. It is widely understood to mean uncertainty in the contractual terms and/or the uncertainty in the existence of an underlying asset in a contract. The prohibition of the former is positive from a transaction perspective, but the latter creates issues for Islamic scholars when considering the application of derivatives which may also be considered Maysir (gambling).

### Credit risk analysis of suku structures

Sukuk are notes or certificates that represent ownership of a pool of underlying assets, hence sukuk holders should be entitled to the ongoing cash flows and proceeds of sales from those assets. A key issue to note is that sukuk are not a completely new asset class requiring a new science to analyse, but rather that such securities employ existing financial engineering techniques to create asset-'based' or securitisation structures that are also Shari'ah-compliant.

However, while it may initially appear that many sukuk have assets at their core, a detailed analysis of the commercial terms and legal structure shows that, for some, sukuk performance is not governed by these assets indeed, the credit risk is that of the borrower.

**CHART I: THE 'PURCHASE UNDERTAKING' (STEP 4) LINKS THE SUKUK PERFORMANCE TO THE BORROWER AND WOULD NOT LIKELY BE PRESENT IN A 'TRUE SALE' OR 'SECURITISATION' SUKUK.**



It should be emphasized that, while most sukuk in the market will have assets in the structure, one should only consider them to be asset-backed or assetsecured if the key securitisation elements are in place to ensure that sukuk holders have beneficial title and realisable security over the assets. If this is not the case, then (as is further explained below) Moody's rating is governed more by the borrower risk and Moody's conventional corporate finance analysis applies.

From Moody's perspective, our risk analysis of all the varying Sukuk structures falls into two categories: Asset-backed sukuk, for which the ratings are primarily dependent on a risk analysis of the assets.

Unsecured (repurchase) Sukuk, for which ratings are primarily dependent on the riskiness of the borrower.

#### **Asset backed/Securitization sukuk**

Market participants involved in securitisation will be familiar with the issues that exist in creating non-recourse bond or sukuk whose credit risk performance is determined solely by the underlying assets.

The assets securitised back the financing raised so, even if the original borrower becomes insolvent, the sukuk does not default. While there are many reasons for borrowers to pursue a strategy of asset backed financing, one key driver is that the rating of such instruments can be significantly higher than the unsecured rating of the borrower, thus allowing them to raise [secured] financing at a lower cost. Despite the benefits, such structures are legally complex to execute but Moody's expects to see the first international 'asset-backed' sukuk issues launch this year from the Middle East.

#### **Unsecured/repurchase sukuk**

The majority of sukuk currently are not asset-backed.

The asset performance does not affect the sukuk performance as the borrower undertakes to repurchase the assets (irrespective of value) at maturity. The presence of such an undertaking critically alters the credit risk dynamics of the sukuk structure. Where present, investors have credit exposure to the corporate or sovereign borrower who has the future obligation to buy back the assets, and hence an analysis of these assets becomes irrelevant.

This differs significantly with asset-backed sukuk above, where the rating assigned is not linked to the borrower.

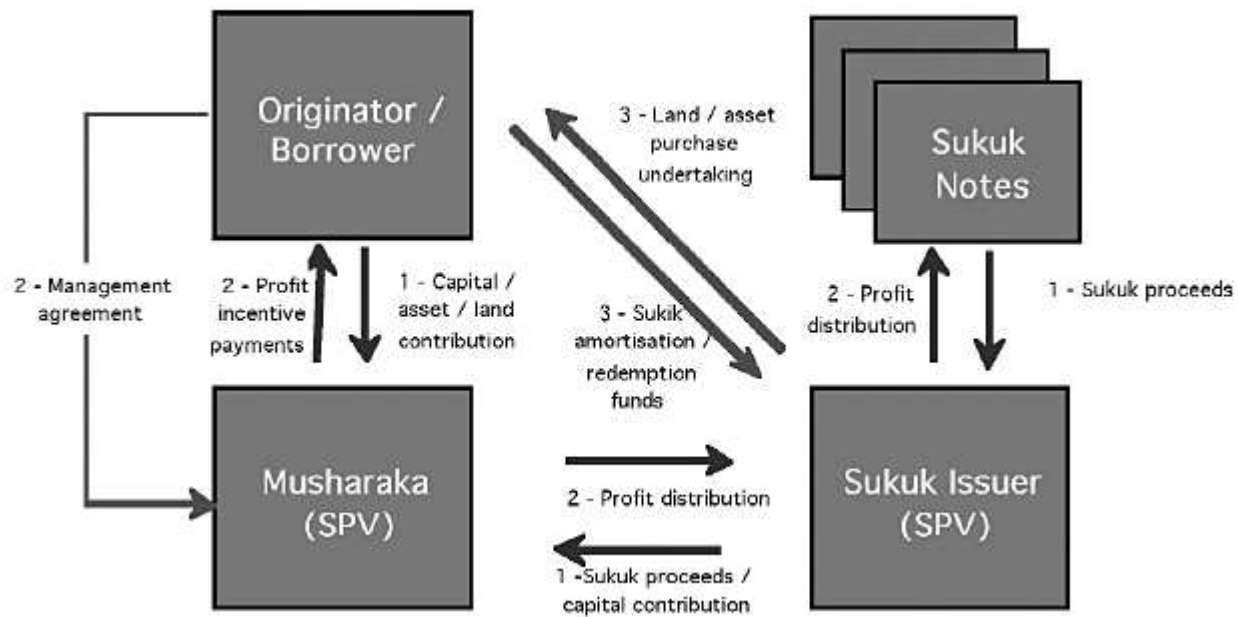
#### **Samples sukuk structures**

##### **Ijara (sale and leaseback) sukuk**

Currently, the majority of sukuk seen to date has been of a simple 'leasing' or Ijara nature.

In such structures, the borrower (or 'originator' in a securitisation sukuk) seeking financing 'sells' the asset to the sukuk Special Purpose Vehicle ("SPV") for a value equal to the financing provided, and then leases it back. The lease payments provide the fixed income stream and may be benchmarked to an index, this sometimes causes debate as to whether it is being used to merely quantify a return (seemingly acceptable), versus implicitly driving the return (Riba).

Sukuk principal repayments can be bullet or amortising, but the critical difference is in how such repayments are effected.

**CHART II: THE 'PURCHASE UNDERTAKING' (STEP 3) LINKS THE SUKUK PERFORMANCE TO THE BORROWER/ORIGINATOR.**

As highlighted in Chart I, most common thus far is a 'purchase undertaking' from the borrower or an affiliate to repurchase the asset at maturity (or upon early termination) for an amount equal to the principal repayment(s) due.

#### **Musharaka (joint venture) sukuk**

The Musharaka structure aims at replicating asset ownership by setting up a joint-venture ("Musharaka") jointly-owned by the issuer (usually incorporated as a SPV) and the borrower/ sponsor. The issuer's and borrower's shareholdings in the Musharaka represent their respective capital contributions based on a parity agreed at the outset, usually comprising of: capital from the issuer (i.e. investor's Sukuk proceeds); and specific assets and 'management skills' from the borrower.

The Musharaka is run under a management agreement by the borrower, which operates the assets and invests the funds held in the JV in accordance with a predefined business plan. Under this structure, sukuk holders are entitled to the issuer's rights in the JV in other words, they have rights to receive payments from the issuer's equity ownership in the Musharaka, as opposed to having rights to indebtedness on borrowed monies, as is the case for conventional corporate bonds.

The nominal amount initially raised may be redeemed either through a number of installments over time under a pre-determined schedule, or at maturity, in each case by application of the purchase undertaking agreement, which stipulates that the borrower is required to buy out a portion or the totality (at maturity) of the issuer's shares in the Musharaka at a price equal to the value of the sukuk to be redeemed. As Shari'ah prohibits the payment of interest, sukuk holders may receive income based on a share of profit generated. An expected 'profit rate' is usually specified that allows the level of return to be compared to conventional bond yield obtained on conventional instruments.

Again, where there is a purchase undertaking, the ability of the issuer to repay sukuk holders is fully reliant upon the existence of this agreement. As a result, Moody's analytical approach for Musharaka transactions is likely to be a two step approach, focusing on the characteristics of the purchase undertaking agreement and (ii) the credit quality of the borrower.

#### **Conclusion**

With its Arabic terminology and unusual prohibitions, Shari'ah and its application to financing can be quite mystifying for the outsider. This article hopes to illustrate the key credit risk and rating drivers, and that the performance of such securities is still driven by cash flows regardless of whether they are sourced from assets or a corporate obligor.

As we can see despite the assets in the structure, the sukuk may yet have credit dependency or linkage to the entity raising finance. In a non-'true sale' Musharaka or Ijara, Moody's needs to conduct a credit risk assessment on the entity required to redeem (via the purchase undertaking) the sukuk. This will in turn drive the credit quality of the sukuk and its rating. However, securitisation or asset-backed sukuk ratings are dependent on the asset quality and, while not yet common, they are closer to the Shari'ah ideals and hence likely to become a more popular Islamic financing method in the future.

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