

# Islamic Securitisation: Practical Aspects\*

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## **Introduction**

The fact that Islamic institutions have a growing participation in the global securitization business is an affirmation of the success they have achieved during the last three decades. Since securitization is a recent invention in conventional financial practices, it is a considerable achievement for Islamic institutions to be involved with this new dynamic line of business. After all, they were until recently struggling to come up with a replacement for products as mundane as saving accounts.

In order to appreciate the importance of securitization to Islamic institutions, one must learn how securitization is commonly understood. Then, it is useful to proceed to highlight the specific concerns of Islamic institutions in the securitization process, and touch upon some limitations of Islamic institutions' practices in securitization. Finally, it is worth elucidating some structures and comment on two case studies. Upon completion of this review, we will understand the importance and the future of Islamic institutions applying this financial method.

## **Definition**

In defining securitization we focus on processes - the process of pooling assets, the process of packaging them into securities, and the process of distributing securities to investors. As Islamic institutions are more concerned with the Islamic acceptability of the securitization business, their focus is more on the content of the "package" rather than the process of packaging. Therefore, they tend to ensure that the assets in the package - and not the package alone - are Islamically acceptable.

A more specific definition characterises securitization as the process of packaging designated pools of assets with or without credit enhancement into securities, and the sale of these securities to the appropriate investors. The process involves the creation of homogenous assets - both in kind and in underwriting criteria - and then pooling them into a significant saleable size. Generally, a pool, on the whole, has a better credit characteristic (through diversification of credit risk, transaction size, geography, etc.) than an individual asset. The process may also involve the provision of additional protection for the investors against late payments, pre-payments, potential write-offs, as well as cash-flow timing mismatches. Such protection is often provided in the form of credit and/or liquidity enhancement schemes, as will be explained later.

## **The Case for Securitization**

Securitization is an American invention, but no longer remains an American curiosity. Almost all the major financial systems have certain securitization schemes. The sale of whole loans could be dated as far back as the 1880's in the USA. The origins of securitization of assets, however, is traced to the 1970's when the Government National Mortgage Association ("GNMA") developed the GNMA pass-through, a mortgage-backed security collateralized by single-family Federal Housing Administration ("FHA") and Veterans Administration ("VA") mortgage loans. Securitization grew into a significant business in the 1990's. Today, securitized assets not only include mortgages on properties, but also credit card receivables, computer leases, equipment notes financing, auto loans, and even future sales of music records. There was even an attempt to securitize the life insurance policies of people with full-blown AIDS, enabling them to

monetize their polices. As one can observe, both Islamically permissible and impermissible assets are routinely securitized in the US and international financial markets.

The growth of securitization is basically driven by four factors; first, the imposition of capital adequacy ratios and reserve requirements on financial institutions by the regulatory agencies have made financial institutions safer place to invest in. But these restrictions have "costs" as they either add direct cost or restrict the ability of these financial institutions to increase their volume of business. Securitization enables these institutions to efficiently remove assets from their balance sheet. It allows them to monetize previously illiquid assets, recycle cash to be reinvested and, hence, expand the volume of their business without a corresponding increase in their equity capital. In simple terms, securitization allows financial institutions to serve more customers without having to raise new funds in the form of either equity or deposits.

Second, whenever the global cost of capital increases, securitization helps financial institutions to raise cheaper capital for their businesses at the asset level instead of the enterprise level.

Third, there is a growing convergence of many capital markets into one, as the barriers between them were removed. As all segments of the economy now compete for the same capital, efficient, low cost of financing have become more necessary.

Fourth, increased ability to generate and utilise information through popular use of **rapidly improving computer technology has resulted in significant gains for the securitization** business. It is now possible to obtain credit and liquidity information on millions of financial assets, enabling the market players to isolate certain types of assets with the objective of making them self-financing. The availability of information enables institutions to remove certain assets from their balance sheets and obtain better credit than what the originators could command in the market, and, hence, lower cost of funding.

These four trends have helped the growth of global securitization industry since the 1980's. By the end of 1994, the total volume of asset-backed securities issued in the USA and Europe alone exceeded 400 billion US dollars, a significant progress for a line of business that was largely unknown before the 1970s. As of this writing, the asset backed markets have blossomed to \$ ? trillion despite the weak global economy.

The securitization process has also some specific benefits for Islamic institutions. As Islamic finance tends to relate finance to assets, asset backed securitization is the right product for Islamic institutions, as long as these assets are structured in accordance with Islamic principles. The concept of asset backing is prevalent in all other Islamically-structured transactions. For example, in trade finance we use "morabaha" contract, which enables the Islamic institutions to purchase certain goods and sell the same to a client at a pre-agreed profit margin, rather than giving an interest-bearing loan to the client, which then purchases the goods. In project finance, we prefer to buy equipment and lease it to a project-promoter, instead of providing him with liquid capital against payment of interest. Therefore, the use of securitization will bring in much needed liquidity to these institutions, by enabling Islamic institutions to free part of their capital which is tied-up with these illiquid project and trade financing activities.

## **Word of caution**

The question, therefore, is not whether Islamic banks should play a role in this dynamic market; it is the "how" which intrigues many market observers. But before we examine the mechanisms to be employed, we should, perhaps, drive home certain realities about Islamic institutions; realities that can sharpen their focus on this line business.

As Muslim-owned banking and non-banking entities, Islamic institutions conduct the major part of their business in the Muslim world. Being a regulation-driven process, securitization, however, is prevalent only in countries with developed regulatory framework i.e., the OECD countries like the United States and United Kingdom and a few emerging economies like Kuwait, Singapore and Malaysia. While Islamic institutions, therefore, can easily securitize the assets they own in the most developed economies, they may not easily do the same with the bulk of their assets in the Muslim world. In addition, the successful use of securitization requires the availability of credit and financial information on the underlying assets, the existence of accounting standards, and the possibility of having some rating systems. None of these conditions are satisfied in most of the Islamic countries. The only exception to this rule is where securitization is employed to raise funds for certain self-contained projects with guarantees from host governments, and with possible backing from international funding organisations, as has been implemented in recent years in countries like Turkey, Pakistan, Malaysia, and Egypt.

When I was at Faisal Finance (Switzerland) in the 1990's or ("FFS"), we opted to use securitization to compliment our investments in real estate and equipment leasing operations in the USA. Through our involvement in securitizations, we have identified four main issues of concern to Islamic institutions:

- ✓ The type of asset must be acceptable to Islamic investors;
- ✓ The structures to be used must be acceptable;
- ✓ A sufficient element of ownership must be conveyed to comply with Islamic principles governing asset sales and assignments; and
- ✓ Any form of credit enhancement must be in a permissible form..

## **The Assets**

As securitization is established and developed primarily in non-Islamic economies, the assets typically included in securitized pools do not necessarily conform to Islamic norms. The assets in Western securitized pools are invariably interest-bearing debt instruments, such as credit card receivables, mortgages, etc. As Islam does not permit the use of interest, it is important for Islamic banks to originate their own Islamically acceptable assets, rather than buy pools of assets in the market. They should therefore use securitization as a secondary tool to provide certain efficiencies to their own operations, and not as a primary business for servicing or underwriting transactions for third-party financial institutions and investors, which are probably non-Islamic in their investment practices. The latter course will invariably involve them in benefiting from restructuring non-halal assets into Islamically permissible investments. As Islam does not permit the payment or receipt of interest, the sale or purchase of debt instruments is not permitted

unless this debt is interest-free and is sold on its face value, which is not the most profitable proposition for any organization.

For an Islamic institution, the underlying assets to be securitized will include leasing, equity ownership, and morabaha contracts. As explained earlier, these contracts may mimic financings by trading or leasing assets and are Islamically acceptable. They are also applied to a wide range of industries, For example, leasing could be applied to funding the lease of equipment required by businesses, funding purchase of computer and cars by individuals, and funding the acquisition of homes by individuals, in effect replacing straight mortgages. In the latter case the ownership of the financed house remains with the financier but the house is leased back to the client with an option or a promise to buy out the house from the financier at a predetermined price at some future date. While the leasing law differentiates between operating and financial leases, this distinction is not very pertinent for Islamic scholars, and are all generally considered acceptable. Alternatively in the housing case, an investor could share equity ownership with a consumer in a house, with a an agreement for the consumer to buy out the investor's equity stake over a specific term at a mutually agreed price and profit. Similarly, morabaha contract could also be used for all the above, but the unsolved issues, including the Islamic restrictions on trading in debts or managing prepayment risk, may limit its use in securitization, but not syndication.

## **The Structures**

In a securitization structure, the players include the originators, servicers, issuers, investment bankers, credit enhancers, rating agencies, and trustees. Originators originate the assets, but can also serve as the servicers, which are responsible for the management and maintenance of assets and the related cashflows. Assets are first sold to Issuers, which are bankruptcy-remote Special Purpose Vehicle ("SPV"). The SPV then issues securities, which are claims on the assets held by the issuer. Such claims carry a specific form of attachment to the ownership of the asset. When assets are not sold to an incorporated SPV, they are sold to a trust, which takes the form of either a guarantor trust or an owner trust. Trusts are created and managed by trustees for the benefit of beneficial owners. Investment bankers underwrite the securities for public offering or place them privately to institutional or wealthy investors, while rating agencies provide the necessary rating, based on certain recommended level of credit enhancement. Finally, the credit enhancers provide the required credit and/or liquidity enhancement, which could be a reserve fund from the asset's cash flow or collateral pledged to support the asset or a guarantee, in order to obtain the required credit rating.

To obtain a reasonable degree of tax efficiency for non-US tax paying investors, it is invariably recommended for Islamic international investors investing in the USA, for example, to set-up their SPVs in a tax-free jurisdiction like the Channel Islands or in a country with a tax-treaty with the USA like Ireland or Luxembourg. The choice depends on the specific tax circumstances of the investor and the underlying asset and trust or SPV. Given the complexity of international tax issues, I recommend consulting with the appropriate experts when structuring investment into the US or other jurisdictions with high taxes for foreign investors.

With this background, we may now specify the three main structures commonly used in securitization. The originators choose between three types of structures; pass-throughs,

asset-backed bonds, and pay-throughs. These structures have been developed in the secondary mortgage and non-mortgage market.

A pass-through represents direct ownership in a portfolio of assets that are usually similar in terms of maturity, yield, and quality. The originator services the portfolio, makes collections, passes them on, less a servicing fee, to the investors. Ownership of the assets in the portfolio lies with the investors; thus, pass-throughs are not debt obligations of the originator and do not appear on the originator's financial statement. Pass-throughs may also be designed to represent an assignment of a portion of ownership, rights and obligations, but not a conveyance of title. Sometimes complex tax or investor issues, and in many Islamic countries, rules restricting foreign ownership of locally domiciled assets require the partial assignment or sale without recordation.

Like the pass-through, the Asset-Backed Bond ("ABB") is collateralized by a portfolio of assets, or sometimes by a portfolio of pass-throughs. The ABB is a debt obligation of the issuer, so the portfolio of assets used as a collateral remains on the issuer's books as assets, and the ABBs are reported as a liability. Also, the cash flows from the collateral are not dedicated to the investors. They are often reconfigured, with the residual often remaining with the issuer/ originator.

One important aspect of the ABBs is that they are over-collateralized, i.e., the value of the underlying assets is significantly in excess of the total obligation. This is largely done in order to provide some level of comfort to the investors.

The pay-through bond, however, combines some of the features of the pass-through with some of those of the asset-backed bond. **The bond is collateralized by a pool of assets and appears on the issuer's balance sheet as debt.** The cash-flow from the assets, however, are dedicated to servicing the bond in a way similar to the pass-throughs.

In addition to collateralized bonds and pay-through notes, commercial paper and preferred stock were also used in the past as alternative structures.

Of the above widely used securitization structures, the pass-through is perhaps the structure closest to satisfying a strict interpretation of Islamic principles. The pay-through, the ABB and the Commercial Paper are debt- structures, which make explicit use of interest. Therefore, only a pass-through with underlying pool of assets structured as morabaha, equity statkes or ijara, could facilitate Islamic institutions to expand their current activities in the securitization business.

Having said that, it is also possible to use certain variations of a pay-through, which closely resemble the pass-through. We may have a pass-through with certain degree of credit enhancement for the investors as follows; [Suleiman – what was your example?]

### **Ownership Conveyance**

The structures that I have discussed must, in order to comply with Sharia'a, transfer some minimum level of ownership. This is not necessarily registered title. It could be a rather simple collection of ownership attributes that allow the investor to step into the shoes of the issuer or co-owner and perform duties related to ownership. Likewise, these could

also be rights granting access, subject to notice. Such access might result in curing a defect caused by the operator or issuer, or even result in the taking over operations by the investor. Such rights and obligations might ultimately empower the investor to take control of the asset and sell it outright into the market place. As we will see in our examples, the level of conveyance varies for practical reasons and our Scholars have asked us to observe a specific level of conveyance in order to avoid the deconstruction of asset investment into debt sale.

All three structures described above may result in the issuance of a number of documents that flow from lessee or home buyer, that is the recipient of the investment to the investor. These may include promissory notes, mortgages or security instruments, and various documents of conveyance or assignment. Generally, these have no bearing on the Islamic contract, assuming that they do not contradict it. For instance, there is no restriction in Sharia'a to promise to make specific payments as is required by a promissory note. But, there are customary judicial procedures that make it difficult for an investor to act against the holder of an asset if a promissory note does not exist. The same applies to security documents like chattel liens or mortgages. Even though the investor has some aspect of ownership, at the end customary procedures in many jurisdictions require the investor to hold a right of enforcement like a mortgage in order to secure legal satisfaction in a contentious case.

There is, however, a single dominant Sharia'a rule governing all documents, namely that they are conveyed together. In an interest bearing securitization, two securities might be derived from a single lease – a principal only instrument governed by the contract of lease and any security instrument, and an interest only instrument governed by the promissory note. This practice is not acceptable in Islamic investing, and an assignment of any document, contract, promissory note or security instrument, must be accompanied by all of the documents. In other words, Islamic institutions are not allowed to derive multiple instruments from one in a manner that creates either the sale of a debt, sale of an isolated cash flow, or a direct interest obligation.

### **Credit Enhancement**

In an effort to obtain best pricing for the securities to be sold by the SPV to the investors, the originator in a traditional securitization chooses to issue two classes of securities, A and B, such that class A gets priority over class B on the payment priority scale. The originator retains security Class B, which is subordinate to class A. In this case, the SPV receives the total cash-flow attributable to both classes of securities and distributes the same in the order of priorities stipulated in the incorporation documents. This is normally done in order to secure a better rating for the Class A certificates, hence better pricing, which is supported by the cushion provided by Class B certificates.

Under Islamic securitization scheme, we can achieve the same objective by assigning the full ownership rights of the total assets in the pool to class A holders, but with a lease back agreement to lease to the issuer the entire portfolio with some fixed rental payments. The issuer also gets an option (or an obligation) to buy back the entire portfolio at a pre-determined price on some future dates. Both the sale price and the rent are prefixed in order to ensure that the holders of class A certificate get a fair market value for the risks they took.

Another form of enhancement is for the issuer and servicer to set aside some of the asset cash flow that was allocated to them. This becomes a first loss pool, a form of self insurance for the asset pool if you like. In this case, no guarantee, insurance, or complicated buy back structure is required. Sometimes this is a very efficient form of enhancement as some rating agencies will dictate the size of the pool based on the past performance of similar assets, and to everyone's surprise the level of funding is not excessive.

Securitization can also involve other types of credit enhancement such as the creation of spread accounts, bank letters of credit, pool insurance, mono-line insurance for up to 100% of the pool size or straight sub-ordination. We have also touched upon the issue of over-collateralization as provided in the pay-through structure.

Islamic institutions should be very selective in using the credit enhancement methods; the use of some of them changes the character of the transaction. For example, the existence of spread accounts for the excess cash implies the transaction was not a pass-through as the originator was able to keep certain undistributed cash over and above what was paid to the investors and administrators. The investors themselves can, however, willingly deduct part of their income in a reserve account, which is perhaps managed by the investors, to meet eventual losses, if any.

Likewise, the investors may also buy pool insurance, obtain a letter of credit, or blanket the pool with a mono-line insurance. There is nothing wrong with the use of these **products as long as the** investors are willing to buy them and have the choice to use or not to use them. Likewise, it is possible for the Islamic investors to use certain liquidity facility to cover any possible temporary shortfalls, due to mismatches in cash-flow timing, etc., as long as these facilities are arranged on terms acceptable to Islamic practices. Perhaps the best way to explain securitization is to take some case studies as follows;

### **Case Studies**

In 1994, FFS undertook the securitization of a large Master Lease Investment in a single property in Boston, USA. The securitization was facilitated by the creation of a REMIC - Real Estate Mortgage Investment Conduit - to which the Master Lease was deposited. The securities were sold to a major insurance company in U.S.A., which was comfortable with the Master Leases characteristic of the underlying assets as against straight mortgage. The securities were issued in accordance with characteristics, which conform to the established norms of the business. These characteristics included the issuance of tranche B certificate retained by FFS by way of providing over collateralization for the buyer of the senior securities. This over-collateralization was achieved in accordance with the arrangements explained earlier in this presentation. Through the engineering of the deal, FFS was able to enhance its return on the underlying fixed-income asset by more than 1.25%, without changing its risk profile in the deal. In fact, with the underlying master lease being retired on an early basis, the enhancement of the early termination payments on the lease provided FFS with an internal rate of return of over 14%, net of fees. This was all established through securitization process. This also was the first U.S. securitization of an asset specifically originated on an Islamically acceptable basis.



In 1998, FFS utilised the new FASIT laws to pool more than \$50 million of Master Lease assets into a trust. FASIT stands for Financial Asset Securitization Investment Trust; it is a type of trust established in the 1990's under United States law, for use in pooling various types of assets in order to issue securities backed by those assets. The trust pool can be established with various types of assets.

In creating the FASIT, FFS originated assets from some of its sister organizations as well as from U.S. corporations. The assets consisted of Islamically acceptable Master Lease financings on properties.

The FASIT was set up with Crescent Capital (Jersey) Limited, an affiliate of FFS, as the depositor, contributing 13 assets, all Senior Master Lease financing on commercial building in the U.S. ranging in size from \$2.5 - \$8.5 million. The FASIT was engineered with three classes of securities, with the fast-pay amortizing class A being sold to a major insurance company, and the remaining other two classes held by an FFS affiliate.

This is consistent with the Islamic practices as we ensured that not only the underlying financial assets all conform to Islamic principles, but that the trust structure allowed investors to have ownership rights in the trust. The sub-ordinate classes were held by the issuer and not sold to other investors.

The FASIT allows for replacement of any asset (subject to approval rights), which will allow the equity owner of the property to be able to sell unencumbered so long as a suitable asset is available for replacement. The FASIT is designed to provide for all of the deals to achieve long-term permanent financing, but with the flexibility of pre-payment through the replacement mechanism. This is a great benefit to equity investors in the various FFS funds, which own the assets. The FASIT also provided a significant net capital gain on the sale of the securities.

The Freddie Mac process recently instigated in the US is another example of a securitization process. The Federal Home Loan Mortgage Corp. also called Freddie Mac has committed to expanding home ownership among a wide variety of US citizens deemed to be under housed. Freddie Mac's research has shown Muslims to fall into that category. Initially, the program worked with 'lease to own' Islamic structures, but it is planned to include declining balance partnership structures like those employed by Guidance Residential, LLC. In this process, the originator, a bank or mortgage bank invests in the property (sometimes using trusts and sometimes using SPV's) either as sole owner or as co-owner. To facilitate US legal custom and comfort Freddie Mac, the consumer agrees to a form of note and the ownership of the property grants a security interest in the property. These together are then assigned to Freddie Mac, which may or may not hold them in its own portfolio or set up a special Islamic portfolio for international investors. Prior to the Freddie Mac commitment, Muslims paid huge premiums for mortgage alternative programs, up to 5% over the conventional market. Thanks to this new process, Muslim consumers face marginal differences in cost compared to conventional mortgage loans, but comply fully with Sharia'a.

Each of these examples is a distinct, but constructive live example of how Islamic institutions have used securitization for the benefit of both Muslim investors and consumers.

## **Conclusion**

Since its debut in the early 1970's, securitization has grown into a significant business, with credible players and definable rules. It is driven by enactment of various legislation, which made the widespread use of securitization possible. Securitization created net gains for the community as almost everybody gained something from the process. It reduced overall industry concentration risks, resulted in better transparency of operations, imposed industry bench-marks, created significant fee-income for originators and investment bankers, reduced cost of funding to businesses and consumers, and provided better returns for investors.

**As information about pools of assets become more and more available -through more extensive use of electronic information providers like the Internet, through deregulation of global financial markets, and as a result of on-going globalisation of banking and finance - it is envisioned that securitization business will only grow. The trend is also consistent with the growing demand for disintermediation in the financial markets, which is widely documented.**

Islamic institutions, on the other hand, have all along promoted a philosophy in financing based on direct asset financing, rather than lending funds to entities and individuals. They have all along suffered from having to deal with financial intermediaries whose interest-based products are not Islamically acceptable. Securitization enables Islamic institutions to by-pass these shortcomings by engaging themselves directly with the assets to be financed, and with investors in the pools of these assets. It also enables Islamic institutions to negotiate the Islamic acceptability of the terms under which the users hold these assets.

Because of these benefits, we consider securitization as yet another venue for Islamic institutions to demonstrate their competitiveness and to broaden their markets.