

## **Property Finance Based on Sukuk and Conventional Covered Bonds – Requirements for Establishing a Liquid Market: a Comparative Study**

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*There is an urgent need for funding affordable housing in MENA countries and Asia, preferably long-term and maturity-matching. This requirement can be met particularly well by Sukuk and Covered Bonds. The resilience of Covered Bonds and Sukuk depends on the quality of cover assets, strictness of regulatory requirements, soundness of governing jurisdictions, and the certainty of property rights. Following the example of successfully established Covered Bonds frameworks, the following pre-conditions for establishing a liquid market can be identified: stringent requirements re. underlying assets, mandatory regulation of insolvency remoteness of cover pools, independent government supervision, and effective trading platforms. The aftermath of the credit crisis might well be an era of collateralised funding on the basis of good quality assets, of which Sukuk deserve to have their share. It might be advisable to start the development of the necessary Sukuk framework as soon as possible to benefit from the new wave. Apart from Asian and traditional Muslim countries, several EU countries are trying to accommodate Sukuk.*

**Keywords:** Funding, Property finance, Securities regulation, Sukuk and Covered Bonds standards

### **Introduction**

Securitised funding and finance instruments for real estate transactions have been developed both in Islamic and conventional economies. They may be structured as Sukuk or Covered Bonds - both types are based on real estate assets and income streams generated by such assets. The recent global financial crisis has demonstrated that the key to the future of these instruments lies in their safety from the investors' perspective, a great deal of which is determined by legal certainty. The purpose of this study is a comparison of the legal environments of both the Islamic and the conventional structure in order to identify key factors of success and legal gaps in respect of sound and solid Sukuk and Covered Bond markets. The scope encompasses mainly the GCC and Malaysia as far as Sukuk are

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concerned, and the EU in respect of Covered Bonds (the US have not yet finalised related legislation).

Following a brief overview of the requirements of sustainable property finance ( Chapter 1 ), Chapters 2 - 3 deal with a comparison of the characteristics of Sukuk and Covered Bonds, whereas chapters 5-9 try to define recommendations for and requirements of solid and liquid Sukuk and Covered Bond markets. Specific Shari'ah-related aspects can be found in Chapter 11, cross-border issues in Chapter 10. Finally, certain specifics of Sukuk-based property finance in MENA countries and Asia are analysed in Chapter 12. The study closes with an overview of the current situation of Shari'ah-compliant finance and the prospects of Sukuk issuance under EU jurisdictions ( Chapters 13 and 14).

As to methodology, anyone interested in the subject is confronted with certain deficits of comprehensive scientific literature available in respect of both Sukuk and Covered Bonds, particularly in English. This is due to the fact that the specifics of these financial instruments are still being shaped or are at least under review in many national jurisdictions. To a large extent, the author had to make judgements based on his own knowledge of primary legal sources, and his practical experience in the field. This was complemented by using papers written (though occasionally with certain biases) by rating agencies, law firms and associations of the finance industry, as well as issue memoranda.

As far as literature on the subject is concerned, quite a few publications on the general structure of Sukuk and Covered Bonds are available, as well as on Shari'ah compliance of the various specifics of Sukuk. However, analyses of implementation in the individual national jurisdictions are scant at best. Regarding jurisdictions with long-term traditions in Covered Bonds issues such as Germany and Scandinavia, the situation is better. Nevertheless, further in-depth analysis of individual national legal environments is crucial for the assessment of legal certainty. This would be highly appreciated by both academics and practitioners.

Unfortunately, the subject of implementing Shari'ah-compliant finance in the Western Hemisphere, in particular the EU, has attracted only selective publications on items such as contractual clauses, tax issues etc., frequently driven by current events.

## **1. Requirements of Sustainable Property Finance**

There is an urgent need for affordable housing in MENA countries and Asia, due to sheer pressure of population growth. With regard to the Kingdom of Saudi Arabia, e.g., we estimate private and public developers will need to build about 275,000 units a year through 2015, for a total of 1.65 million homes over six years...<sup>2</sup> Expanding the scope of financing for home purchases would form a critical component of housing reform measures...<sup>3</sup> The recent Credit Crisis has demonstrated the need for a reliable funding basis across economic cycles – not only in the emerging, but also in the “old” economies. Funding instruments should, at least to

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2     □     Skafianakis, John / Merzaban, Daliah / Al Hugail, Turki A., Under construction, Saudi Arabia Economics ( ed.: Banque Saudi Fransi ), 20th March 2011, p.1.

3     □     Ibid., p.9.

a large extent, be long-term to avoid temporary liquidity bottlenecks, and match the maturity terms of the assets to be financed.

These requirements can be met particularly well by Sukuk<sup>4</sup> and Covered Bonds. Although bank deposits are a feasible funding source as well, they can be volatile at times. As property finance is medium- to long-term, accurate maturity matching using term deposits is not possible. The new liquidity regime for banks set by the Basle Committee and by the AAOIFI<sup>5</sup> will require enhanced liquidity management including capital market instruments.

## **2. Sukuk and Covered Bonds: Common Basic Principles**

Payment claims of investors are covered by assets ( in this case: real estate assets ) and income streams generated by these assets. The related legal basis – in particular coverage requirements – can be statutory, i.e. prescribed by law, decrees etc. ( examples: Covered Bonds, defined and regulated by several EU jurisdictions, e.g. German Pfandbriefe ) or contractual, i.e. based on individual documentation ( examples: recent Sukuk issues; non-regulated Mortgage Backed Securities. ).

## **3. Sukuk and Covered Bonds: Characteristics**

Although Sukuk and Covered Bonds are based on a common principle, each of them have very specific characteristics of their own::

3.1 Sukuk are instruments where the interest in assets and related revenues is securitised. They can mature at a set date. However, as a Shari'ah-compliant type of security, they do not guarantee repayment or a profit. Further, the underlying assets and the issuer itself must be Shari'ah-compliant, in particular in respect of the bans of Riba, Gharar, Maisir, and Zulm.<sup>6</sup> The AAOIFI provides the following definition: „Investment Sukuk are certificates of equal value representing undivided shares of ownership of tangible assets, usufruct and services or ( in the ownership of ) the assets of particular projects or special investment activity, however, this is true after the receipt of the value of the Sukuk, the closing of the subscription and

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4  Farhan, Malik, Sukuk-based Securitization for Development of a Stable and Thriving Housing Market, 2010; Alsayyed, Nidal / Farhan, Malik, Sukukization: Islamic Economic Risk Factors in Shari'ah View, MPRA Paper No. 20675, Library of Munich, Germany, 2009; Thani, Nik Norzrul / Othman, Aida, Islamic Financial Products and Concepts, London 2011, Chapter 18.

5  Accounting and Auditing Organisation of Islamic Financial Institutions

6  For definitions see Alsayyed, Nidal A., The Guide to Islamic Economics, Banking and Finance, MPRA Paper 20128, University Library of Munich, Germany, 2009; see also Islamic Finance in Terms, Sukuk Ijara, A Securitization by another Name, Thomson Reuters Westlaw Business Currents 9th July, 2009.( available online at [currents.westlawbusiness.com](http://currents.westlawbusiness.com) ); Thani / Othman ( supra FN 4 ).

employment of funds received for the purpose for which the Sukuk were issued...As for debts, owed as a liability, it is not permissible to securitize them for the purpose of trading“<sup>7</sup>

3.2 Covered Bonds are securities, where the obligors' payment obligations are covered by assets ( in this case: real estate assets resp. related mortgages ) and by income streams generated by these assets. There is a restricted definition with specific requirements for privileges under the EU Capital Requirements Directive ( „CRD“, Basel II/III ). In conventional banking, Covered Bonds are normally structured as debt securities.

#### 4. Lessons of the Credit Crisis

Banks applying the principles of Islamic Finance have performed fairly well during the crisis.<sup>8</sup> They cannot escape the deterioration of the global economy and falling asset prices. However, they were not much affected by the first round core crisis, because they are much less exposed to the systemic drivers of the liquidity squeeze: Due to the closer link of Islamic Finance instruments to the real economy, there is less leverage in the system. In general, Islamic banks have a strong commitment to asset-based transactions, which insulates them from specific internal risks of the financial system. Therefore, accommodating Islamic Finance in conventional banking systems could be a stabilising factor.

Strictly regulated statutory Covered Bonds have weathered the crisis fairly well, too, compared to other capital market funding instruments. There was a reasonable degree of secondary market liquidity for classified Covered Bonds under stringent European and other international legislation, whereas the MBS markets practically dried up. Although related spreads had widened significantly during the crisis, they have come down in the meantime. But the financial world has changed. The uniformity of the Covered Bonds markets is over. Issues under stringent jurisdictions are sought after, others are frequently not marketable. A substantial share of those issues in demand is taken up and held by central banks, in particular in Asia.

These experiences have demonstrated that the resilience of Covered Bonds depends on

- the quality of cover assets;
- the strictness of regulatory requirements;
- the soundness of the governing jurisdiction, in particular in respect of the certainty of property rights.

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7     □     AAOIFI Standard for Investment Sukuk ( 2003 ), Art. 2 and 5/1/2.

8     □     Hasan, Maher / Dridi, Jemma, The Effects of the Global Crisis on Islamic and Conventional Banks, a Comparative Study, IMF Working Paper WP/10/201, Sept. 2010; Follak, Klaus Peter, International Law Assoc. Committee on International Monetary Law ( MOCOMILA ) Meeting in Kuala Lumpur September 2009, Bank Negara, Update on Regulatory Issues in Respect of the Credit Crisis, part 10; Thani, Nik Norzrul, International Law Assoc. ( ILA ) Committee on International Securities Regulation, Materials Submitted to the 74th Conference ( The Hague, 2010 ), available online at <http://www.ila-hq.org/en/committees/index.cfm/cid/23>, pp.58.

Clearly, statutory Covered Bonds regulated by mandatory law had, and still have a competitive edge. The post-crisis scenario during the next few years will be an era of collateralised funding and covered funding instruments.

### 5. Sukuk are Catching up, but there is Need for Improvement

The global outstanding Sukuk volume may expand to USD 200bn in 2010, compared to USD 97bn at yearend 2007<sup>9</sup>. In 2010, Sukuk issuances hit a record of USD 47.78 bn if compared to the last five years.<sup>10</sup> These growth rates should qualify Sukuk for the following targets:

1. Establishment of a global wholesale funding instrument for Shari'ah-compliant finance of real estate, including residential property;
2. establishment of a capital market instrument with sufficient critical mass to be used as collateral for transactions of Islamic banks with domestic and international central banks.

The need for increasing the supply of liquid high-quality assets<sup>11</sup> has been underscored by the recent liquidity squeeze: „...the development of a domestic bond market would provide a mechanism to manage systemic and private sector liquidity more smoothly across cycles...U.A.E. banks' liquidity risk management capacity is constrained by an insufficient diversification of the liquidity base...local banks had to rely on the growth of their deposit base, and had to borrow abroad with little insurance on the rollover prospects in case of tensions...“<sup>12</sup> Sufficient central bank liquidity in the traditional Western hemisphere for Islamic Finance institutions is still a challenge;<sup>13</sup> enhanced liquidity management for Islamic Banks is a necessity.<sup>14</sup> The basic requirements would be a critical mass sufficient for a benchmark curve over a full range of maturities up to 10 years, as well as beneficial pricing to cater for advantageous funding of Islamic residential real estate finance.

Listing of Sukuk at international stock exchanges does not cause any major problems, and Sukuk are increasingly attracting not only Islamic, but also conventional fixed-income debt investors. However, the Sukuk market is still fragmented and confronted with a lack of depth,

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9 □ UK HM Treasury / FSA, Consultation on the legislative framework for the regulation of alternative finance investment bonds ( sukuk ), Dec. 2008, p.9.

10 □ El Aasser, Mahinaz, IFIS Global Sukuk Market H2-2010 Report, [www.securities.com/ifis](http://www.securities.com/ifis), p.2.

11 □ A. Chailloux / D. Hakura, Systemic Liquidity Management in the U.A.E.: Issues and Options, IMF Working Paper WP/09/261, Dec. 2009, p. 4.

12 □ Ibid., pp. 4, 13, and 14.

13 □ Islamic Finance in Saudi Arabia, speech by M. Al-Jasser, Governor, Saudi Arabian Monetary Agency, at the BaFin Conference on Islamic Finance, Frankfurt 29th October 2009.

14 □ Hasan / Dridi ( supra FN 8 ), p.33.

<sup>15</sup> and a liquid secondary market is essentially non-existent. <sup>16</sup> With growing competitive demand for available liquidity in a still risk-averse environment, action is required. This has been confirmed by the World Bank Group at the 8th IFSB<sup>17</sup> Summit in Luxembourg, May 2011, stating that „...the legal underpinning of Islamic transactions is not yet robust, especially in the case of dispute there remains uncertainty whether the court ruling is based on Shariah or civil law; there is also uncertainty of how insolvency and default should be handled; further problems being the different interpretations of Shariah rulings across jurisdictions; the lack of standard documentation which in turn contribute to the high cost of transactions and financing and the pressing issue of liquidity management in Islamic Finance.“ <sup>18</sup>

### **7. Sukuk and Covered Bonds: Recommended Requirements – Certainty of Property Rights**

The soundness of the governing jurisdiction, in particular the certainty of property rights, is a major factor in attracting investors. „The absence of a clear mortgage law framework to govern property ownership, property repossessing, enforced eviction and asset liquidation in the case of delinquency has deterred banks from extending lending“.<sup>19</sup> Therefore, e.g., the methodology of Rating Agencies caters for jurisdiction-based rating uplifts.

Basic legal requirements are:

Clearly defined and enforceable property rights covering ownership, pledges ( mortgages), transfer and collateral for claims.

2. Property rights must be unambiguously allocated to owners and beneficiaries. This can be achieved by official registers established with public faith.
3. Property rights must be unambiguously allocated to the underlying physical real estate. This can be achieved by land registers based on an official public cadastre.
4. The judiciary system must ensure reliable and speedy enforcement and execution of property rights.

Although the legal environment of the typical Sukuk target countries in MENA and Asia differs significantly, good progress has been made or is under way. Thorough and easily available analyses of each individual jurisdiction similar to those ones existing on Eastern Europe <sup>20</sup> would be very desirable for practitioners and academics as well. There are

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15    □    Ibid.

16    □    McMillen, M.J.T., Securities Laws, Enforceability and Sukuk, Islamic Financial Services Board ( Ed. ), Islamic Finance: Surveys on Global Legal Issues and Challenges, Kuala Lumpur 2008 p. 93.

17    □    Islamic Financial Services Board

18    □    Indravati, Sri Muliani, Managing Director of the World Bank Group, quoted by Parker, Mushtak, arabnews.com, May 16th, 2011.

19    □    Skafianakis, John / Merzaban, Daliah / Al Hugail, Turki A ( FN 1 ), p. 11.

20    □    E.g. by the Center of Legal Competence, Vienna ( website: [www.clc.or.at](http://www.clc.or.at) ).

sophisticated private law systems in place in countries such as Malaysia.<sup>21</sup> The UAE have introduced related legislation. The draft mortgage law of the Kingdom of Saudi Arabia is close to introduction. It will obviously contain „five components, including regulations on mortgage registration, enforcement, financial leasing companies, real estate financing companies and general finance companies. It is crucial that the law set up a central body to register title deeds, replacing the current system of having notaries public record deeds in a less-standardised way.“<sup>22</sup>

## **8. Sukuk and Covered Bonds: Recommended Requirements - further Legal Basics**

The soundness of the governing jurisdiction has to include:

- a clearly defined and enforceable legal basis for securities, transfer of claims and rights, and securitisation, as well as for exchanges and regulated markets<sup>23</sup>;
- clearly defined and enforceable corporate law in respect of issuing entities;
- a clearly defined and enforceable legal basis for insolvency and insolvency remoteness.

## **8. Sukuk and Covered Bonds: Recommended Specific Requirements for a Successful Introduction**

As we have seen, statutory Covered Bonds regulated by mandatory law have a competitive edge. This is why even in the USA, traditionally the country of contractual MBS, explicit legislation is being prepared<sup>24</sup>, not to mention jurisdictions such as Canada, Korea and the UK. Following the example of successfully established Covered Bonds frameworks, certain issues should be mandatory:

1. Stringent requirements re. eligibility and quality of underlying assets: real estate and/or related revenues ( e.g. ijara or rental income ) with certain risk restrictions ( „LTV ceilings“ or „over-collateralisation“). How the latter requirement can be

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21  In Malaysia, based on Common law.

22  Skafianakis, John./ Merzaban, Daliah/ Al Hugail, Turki A ( FN 1 ), p. 11.

23  See in general Gray, Simon/ Felman, Joshua/ Carjaval, Ana/ Jobst, Andreas, Developing ASEAN Bond Markets: What still needs to be done? IMF Working Paper WP/11/135, June 2011, and Goswami, Mangal/ Sharma, Sunil, The Development of Local Debt Markets in Asia, IMF Working Paper WP/11/132, June 2011.

24  Draft United States Covered Bond Act of 2011, 112th Congress 1st session. Until then, there was only an FDIC statement on the treatment of covered bonds that fulfill certain minimum criteria, followed by a Treasury statement on „best practices“ ( both 2008 ). So far, there were no issues from US banks under that framework. Based on the current situation lacking explicit regulation, the Standard & Poors uplift allowance based on legislation for the US is in the same range as Greece ( 3 – 5 notches ) versus 5 – 7 for Germany and France.

achieved applying Shariah-compliant structures, would have to be subject to further in-depth investigations. For example, risk and profit sharing with an interbank or government agency might be considered. Residential property should be included in any case to achieve a satisfactory market depth – over 70% of the Islamic Finance market is based on consumer finance, due to demand by the Muslim Middle Class.<sup>25</sup> Simply relying on fragmented commercial property projects would not be enough. Apart from that, claims against public-sector entities would be possible, to enable Public Private Partnership finance for public-sector properties such as hospitals etc.<sup>26</sup>

2. Cover pool structure and insolvency remoteness: at least under the jurisdiction of the issuer, clear and, if necessary, separate insolvency procedures for cover assets should be established. In merely contractual structures lacking cover pool-specific legislation, „...there are potential challenges which could threaten the priority of the bondholders with respect to the cover assets.“<sup>27</sup> Related challenges are in particular implied by the risk of re-classification of „true sales“ to bankruptcy-remote vehicles by originators into „secured lending“ under common law ( claw back risk ). This is why, e.g., the

Canadian government is considering specific legislation.<sup>28</sup> With a view to Sukuk, specific legislation seems even more advisable, because „...insolvency procedures subject to *Shariah* could displace investor protection ( such as bankruptcy remoteness and repayment guarantees ), leading to a reclassification of collateral assets as part of the bankruptcy estate of the originator.“<sup>29</sup>

Again, how this requirement can be achieved by applying Shariah-compliant structures, would have to be subject to further in-depth investigation. Three alternative models are customary in the conventional Covered Bonds industry:

- Preferential claim of bondholders on a segregated asset pool of the issuer ( i.e. not part of its insolvency estate ). If the issuer is insolvent, the cover pool assets are used exclusively to satisfy the claims of covered bondholders ( German Pfandbriefe ).
- Insolvency-remote subsidiary: the cover assets are transferred to an insolvency-remote subsidiary which uses these assets as coverage for covered bonds – explicit

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25 □ Ibrahim, The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration, 23 Am.U.Int'l L.Rev. ( 2008 ), p. 667.

26 □ The Ijara Sukuk issued in 2004 by the German regional government of Saxony-Anhalt, listed at the Luxembourg stock exchange, is an example ( Standard & Poors press release 9th July, 2004 )..

27 □ Mackie, John, Covered Bonds: Canada Examines Asset Segregation and Insolvency Priorities, Thomson Reuters Business Law Currents, June 16th, 2011, available online at [currents.westlawbusiness.com](http://currents.westlawbusiness.com).

28 □ Ibid.

29 □ Thani ( supra, FN 7 ), p. 60.

legislation, as opposed to a merely contractual framework ( French Obligations Foncières ).

- Transfer of the cover pool to a guaranteeing vehicle; a subsidiary of the above-mentioned type issues a guarantee for a bond from the originating bank ( UK model ). Due to the guarantee-based structure, Shari'ah compliance might be hard to achieve.
3. Regulation for the orderly continuation of the cover pool ( as opposed to acceleration) in case of the issuer's distress. In particular, the pool will need to have access to liquidity, e.g. by central bank liquidity lines.<sup>30</sup>
  4. Ongoing governmental supervision of the issuing entity and the cover pool ( including on-site assessments ).
  5. Market making for benchmark issues, possibly by involvement of central banks. In particular, the criteria of benchmark issues should be explicitly defined. Central bank purchase programmes might support a kick-start. In case of European Covered Bonds, a related European Central Bank ( ECB ) purchase programme has been of significant help after the crisis.<sup>31</sup>

## **9. Establishment of a Liquid Market for Sukuk and Covered Bonds**

Liquid capital markets have to meet the following basic requirements:

- sufficient market depth, i.e. the ability to absorb large transaction volumes without a significant change in prices;
- tightness of bid-ask spreads to cater for cost-efficient trading;
- ability to absorb random shocks in respect of day-to-day price volatility.<sup>32</sup>

Sukuk and bond markets in the MENA region and Asia are still confronted with a couple of deficiencies. As less liquid markets they are characterised by a narrow investor base, insufficient infrastructure, low market transparency, and lack of timely information.<sup>33</sup> The following impediments can be identified:<sup>34</sup>

- lack of critical size in issuance;
- lack of a diverse investor base;
- gaps in the legal and regulatory framework;

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30     □     This issue is also being discussed in the US initiative mentioned supra, FN 24.

31     □     Announced in May 2009, to be phased out in June 2010.

32     □     Goswami/Sharma ( supra FN 23 ), p. 13.

33     □     *ibid.*

34     □     *ibid.*, p.16.

- tax and capital controls for foreign investors;
- weaknesses in corporate governance;
- inadequate market information;
- high issuance and transaction costs;
- lack of pricing benchmarks and hedging instruments;
- lack of robust frameworks for asset-backed securitisation.

„The US subprime mortgage crisis has exposed the danger associated with securitization. By learning from this, Asian countries can adopt a simpler and more robust securities system. To this end, market participants, regulators, and other shareholders will have to build supporting institutions and capabilities to ensure strong prudential norms for regulation, capital adequacy, liquidity, valuation, and special purpose vehicles. Therefore, comprehensive securitization laws, lower tax and registration impediments for securitized transactions, investor education on securitization, and stronger foreclosure norms ( especially on mortgages) could help provide the foundation for an ABS market.“<sup>35</sup>

Against this background, a few specific requirements can be identified:<sup>36</sup>

- existence of regulated exchanges with a robust legal framework;
- effective trading platforms, ideally enhanced by market-making abilities of primary dealers;<sup>37</sup>
- existence of reliable depository, settlement and payment systems, including central clearing counterparties;
- pricing transparency including OTC ( Over the Counter ) markets, enhanced by reporting obligations imposed by regulatory authorities, and providing investors with access to indicative price quotes;<sup>38</sup>
- existence of benchmark yield curves covering the full range of maturities, in order to facilitate price discovery in private securities markets. As such benchmarks are traditionally based on government securities, even governments that do not have financing requirements should build related yield curves.<sup>39</sup> Related benchmarks must be suitable for Shari'ah-compliant instruments.
- existence of functioning repo and hedging ( derivatives ) markets;
- existence of rating agencies familiar with the specificities of Shari'ah-compliant structures.

## 10. Sukuk and Covered Bonds: Cross – Border Transactions

Three jurisdictions would be involved:<sup>40</sup>

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35 □ *ibid.*, p. 26.

36 □ See in particular Gray et al. ( *supra* FN 23 ), pp.3.

37 □ Goswami/Sharma ( *supra* FN 23 ), p.13

38 □ Goswami/Sharma ( *supra* FN 23 ), p. 24.

39 □ *Ibid.*, p.23 quoting the example of Singapore.

The jurisdiction governing the formation of the entities involved, in particular the issuer;  
the jurisdiction in which the underlying assets ( real estate ) are located;  
the jurisdiction governing the transactional documentation..

Cross-border harmonisation of related private law issues is not realistic and has not even been tackled in the EU. Nevertheless, enforcement of foreign judgements and choice of law (conflicting law ) rules must be clear and agreed upon. Even on the basis of proper choice of law rules, there is a remaining risk in respect of cross-border insolvency, because insolvency law is national and not contractual. Solutions could be possible by establishing contractual security or access rights for the benefit of the bondholders as an add-on to related privileges under the issuer's jurisdiction. In addition, cross-country clearing and settlement arrangements for securities are essential.<sup>41</sup>

„The promotion of a thriving global market for Islamic products is...dependent on strong co-operation among regulators to maintain a high level of investor protection across borders.“<sup>42</sup>

Therefore, it is encouraging that harmonisation efforts outside the EU are increasing. To mention just a few examples:

The AAOIFI Standard for Investment Sukuk ( 2003 ) including the Clarification of March 2008;<sup>43</sup>

Agreements of mutual recognition of common standards, e.g. GCC/Malaysia

### 11. Shari'ah Issues of Sukuk

Any in-depth analysis of the Shari'ah issues involved in individual national and cross-border Sukuk markets would by far exceed the scope of coverage of this study.<sup>44</sup> Nevertheless, the basic requirements should be remembered:

- The underlying assets must be Shari'ah-compliant, as well as the issuer itself. This excludes prohibited activities such as traditional finance, where Riba is charged;<sup>45</sup>

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40          For a comparative summary of national securities laws, see McMillen, M.J.T.( supra FN 16 ), p. 93.

41          Gray et al. ( supra FN 23 ), p.4.

42          Anwar, Z., Malaysian SC Chairman, Re-examining Approach and Philosophies on Regulation of the Markets, Quarterly Bulletin of Malaysian Islamic Capital Market, Vol. 4 No.2, June 2009.

43          AAOIFI Standard for Investment Sukuk ( 2003 ) including the Clarification of March 2008, and, in particular in respect of asset securitisation, Quarterly Bulletin of Malaysian Islamic Capital Market, Vol. 4 No.2, June 2009.

44          As for the basics, see the AAOIFI Standard for Investment Sukuk ( supra FN 43 ), commonly known as AAOIFI Shari'ah standards 13 and 17; see also Alsayyed, / Farhan ( supra FN 3 ).

- the ban of Gharar – any excessive ambiguity, uncertainty or lack of specificity affecting the principal components of the contractual framework;<sup>46</sup>
- the ban of Maisir ( speculation with the element of gambling );<sup>47</sup>
- the ban of Riba ( the fixing in advance of a positive return on capital as a reward for waiting);<sup>48</sup>
- the ban of Zulm ( acts that are considered to be oppressive and abusive to the health and moral of the society ).<sup>49</sup>
- According to the AAOIFI Investment ( tradeable ) Sukuk standards<sup>50</sup>, Sukuk have to represent ownership of the securities holders in the underlying assets.

If and how the specific Shari'ah issues can be accommodated, depends on the individual national jurisdiction including private law. In particular, it might be a challenge to transfer a sufficient interest in the underlying property rights to the holders of Sukuk using efficient procedures under certain civil law jurisdictions.<sup>51</sup> On the contrary, the common law trust model allows for insolvency-proof equitable ownership interest of the beneficiaries ( holders of securities ) in the underlying real estate, whereas the issuing entity can retain the legal ownership. Comparable structures are compatible with Islamic law.<sup>52</sup> Further, scholars in a number of Islamic jurisdictions state that murabaha debt cannot be securitised.<sup>53</sup> However, the prevailing view of Malaysian scholars differs, as long as the underlying receivable is connected to a true trade transaction.<sup>54</sup> In an alternate form of Ijara contracts, known as Ijara-wa-iqtina ( „rent-to-own“ ), the lessee will eventually own the leased property. A portion of the monthly payment installment is considered rent for use of the property, while the other

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45 □ A.H. Abdel-Khaleq / C.F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 *Chi.J.Int'l L.* ( 2007 ), p. 415.

46 □ A. Ibrahim ( *supra* FN 25 ), p. 676; see also Alsayyed / Farhan ( FN 3 ) and Thani ( *supra* FN 7 ), p. 55..

47 □ *Ibid*; see also Alsayyed / Farhan ( FN 3 ) and Thani ( *supra* FN 46 )..

48 □ *Ibid.*, p. 677; ee also Alsayyed / Farhan ( FN 3 ) and Thani. ( *supra*, FN 46 ).

49 □ Thani, *supra* FN 46.

50 □ *Supra*, FN 43. See also Mufti Usmani, *Muhammad Taqi, Sukuk and their Contemporary Applications*, 2008.

51 □ For more details, see below chapter 13.

52 □ McMillen, M.J.T. / DeLorenzo, Sheik Yusuf Talal, *Trust Laws and Islamic Finance*, Islamic Financial Services Board ( ed. ), *Islamic Finance: Surveys on Global Legal Issues and Challenges*, Kuala Lumpur 2008, pp.143.

53 □ Abdel-Khaleq, A.H. / Richardson, C.F., *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, *Chi.J.Int'l L.* ( 2007 ), p. 412.

54 □ *Ibid.*

portion is paid toward ownership until the customer owns 100% of the property, at which title passes to the lessor.<sup>55</sup>

A model where assets based on Musharaka / Ijara, created between an originator and the real estate purchasers, are placed into a bankruptcy-remote entity, a Trust, has been described as well.<sup>56</sup>

Hence, in general Shari'ah-compliant sukukisation of large residential property finance portfolios should be possible. This has been demonstrated by the successful launch of the Cagamas ( national mortgage corporation of Malaysia ) ALIM ( al-Amanah Li al-Istithmar) issue in 2010, which has been very well accepted not only by Asian, but also by GCC investors.<sup>57</sup>

Problems of international transparency can be caused by the fact that the AAOIFI accounting principles are not founded on an interest-based set of principles ( i.e. they cannot be compared with EU or US GAAP ).<sup>58</sup> This could be compensated by clear legal guidelines for the quality of eligible assets and income streams.

## 12. Sukuk-based Property Finance in MENA and Asian Countries

As we have demonstrated, Sukuk would qualify for the following targets:

Establishment of a global capital market funding instrument for Shari'ah-compliant finance of real estate including residential property.

Establishment of a capital market instrument with sufficient critical mass to be used as collateral for transactions of Islamic banks with domestic and international central banks.

The markets have already seen quite a few successful commercial and residential property finance-related Sukuk issues. In the field of residential property, the Cagamas ( national mortgage corporation of Malaysia ) ALIM Sukuk programme launched in 2010, established with a AAA rating by RAM<sup>59</sup> was a landmark.<sup>60</sup> It was structured in a way such as to accommodate stricter Shari'ah requirements of the GCC region including the Kingdom of Saudi Arabia and comprises the following features:

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55    □    Ibid.

56    □    Alsayyed, / Farhan ( supra, FN 3 ).

57    □    For more details, see below chapter 11.

58    □    Generally Accepted Accounting Principles, Mc Millen ( supra FN 16 ), p. 98 .

59    □    RAM Rating Services Berhad, Kuala Lumpur.

60    □    For a detailed description, see RAM Ratings August 2010.

- commingling of 2 different asset classes, i.e. tangible assets ( real estate properties ) and financial assets ( deferred-payment receivables established from commodity trading ),
- real estate properties make up more than 50% of the assets, addressing the issue of Sukuk tradeability in the secondary market;
- the commodity trading component involves sale transactions among 4 or more parties, steering clear from the criticised concept of Inah ( sale and subsequent buyback by the original seller );
- an auction process upon maturity of the Sukuk as opposed to the more common purchase undertaking via Wa'd in order to enhance convergence towards risk- and reward sharing for Sukuk holders.

Nevertheless, any replication of successfully established transaction structures under different national jurisdictions has to be handled with great care, based on an in-depth analysis of the individual legal environment. This is even true in respect of Shari'ah issues: „Islamic jurisprudence is neither definite nor bound by precedent and rulings in one jurisdiction may not be uniformly enforced in others. As a result, the absence of widely recognised standards for *Shariah* compliance may challenge the legal status and restitution interest of investors.“<sup>61</sup> ... „Besides Malaysia, few Muslim countries have enacted special legislation to regulate the business of Islamic banks. Pakistan, Iran, Turkey and the UAE are to be mentioned particularly...Saudi Arabia, however, argues that there is no need for Islamic banks to exist as a separate industry in the country. It pre-supposes that all existing banking laws and practices in that country are necessarily Islamic by default.“<sup>62</sup>

Basically, the Sukuk market is still fragmented and confronted with a lack of depth ( secondary markets are not developed ) even in many Muslim countries. South East Asian markets have been dominated by sovereign, GCC markets by corporate issues.<sup>63</sup> These problems could be tackled by implementing the recommendations introduced ( if appropriate in the national environment ).

„Though difficult, Asian emerging markets have to work further toward harmonizing market infrastructure, notably in trading and clearing platforms, custody arrangements, as well as standardizing valuation rules. To this end, countries should continue to raise domestic standards in line with international best practices.“<sup>64</sup> Whereas Malaysia has extended specific legislation based on the dualism of civil and Shari'ah law already in place<sup>65</sup>, the awareness of related deficiencies is increasing, and there are many encouraging initiatives under way:

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61 □ Thani ( supra FN 7 ), p. 60.

62 □ Rasheed, R., Banks that are not in fact „Islamic“, Islamic Finance News ( [www.islamicfinancenews.com](http://www.islamicfinancenews.com) ), 28th April 2010, p. 14; on the general legal situation of Islamic Finance in the Kingdom of Saudi Arabia see also Hussain, Amjad / Longdon, Alex / Ifawi, Karim, Islamic Finance in Saudi Arabia: Some Reflections, *ibid.*, p. 10.

63 □ El Aasser ( supra FN 9 ), p. 6; Goswami / Sharma ( supra FN 23 ), p.6.

64 □ Goswami / Sharma ( supra FN 23 ), p.27..

65 □ The Shari'ah Board of the Central Bank of Malaysia has the supreme jurisdiction over Shari'ah issues in financial transactions.

- The establishment of the International Islamic Liquidity Management Corporation ( IILM) by 11 central banks and two multi-lateral organisations in October 2010 was a major breakthrough and could be even compared with the importance of the European Central Bank ( ECB ) for the EU financial markets.
- Agreements of mutual recognition of common standards, e.g. GCC/Malaysia.
- An IFSB task force is due to publish recommendations for standard Sukuk structures later in 2011.
- On the domestic side, the introduction of the Saudi Arabian mortgage law has been mentioned above. Another encouraging step is the creation of the Kingdom's Tadawul Sukuk platform for trading and pricing Islamic bonds. To pick a few more initiatives: Singapore has a well-established securities benchmark yield curve based on government securities, and the Hong Kong Monetary Authority launched the Central Money Markets Unit Bond Price Bulletin website providing investors with online access to indicative bond prices quoted by major banks.<sup>66</sup> Another recent issue is a proposal by the Egyptian Financial Supervisory Authority ( EFSA ) explicitly regulating the issuance of Sukuk.<sup>67</sup>

### **13. EU Covered Bonds and Shari'ah – compliant Assets**

Ijara ( lease ) and Murabaha ( forward sale )–based real estate transactions can be structured in a format so as to be eligible under the national covered bonds regime of several EU countries, including German „Pfandbriefe“. However, most EU jurisdictions require cover assets to be located in the EU or in one of very few eligible non-EU countries. Further, the issuing entity needs a banking licence and residence of an EU country.

### **14. Shari'ah – compliant Finance under EU Jurisdictions**

There is a source of capital available which can be tapped only via Islamic Finance. Approx. 14m Muslims are EU residents. Governments world-wide are taking measures to accommodate Islamic Finance and Sukuk, and EU countries are trying to win a share of this fast-growing market.

The first question is whether Shari'ah principles can be agreed upon as law governing financial transactions.<sup>68</sup> Basically, the Shari'ah as such is non-State law. The EU regulation on the Law Applicable to Contractual Obligations<sup>69</sup> caters for incorporation into a contract governed by State law rather than to allow the choice of non-State law as the governing law of contract in general. In respect of the Shari'ah rules under the jurisdiction of an EU Member State, this means:

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66 □ Gray et al. ( supra FN 23 ), pp.23 .

67 □ Amendment to the Egyptian Capital Market Law No. 95 of 1992.

68 □ Follak, Klaus Peter, Shari'ah clauses in financial contracts, Thomson Reuters Westlaw Business Currents January 17, 2010, available on line at [currents.westlawbusiness.com](http://currents.westlawbusiness.com).

69 □ Regulation EC 593/2008.

- The parties may choose any State law which incorporates the rules of Shari'ah as substantive law, e.g. the jurisdiction of the Kingdom of Saudi Arabia.
- *Ινστειαδ*, the parties may choose the Shari'ah as the law of contract, opt out of any national law, exclude dispute resolution before the courts and submit to arbitration. With a view to recent UK judgements<sup>70</sup>, related clauses should be explicit and clear.
- Finally, the jurisdiction of a Member State may allow the choice of non-State law including the Shari'ah. This is generally the case under French law,<sup>71</sup> whereas in Germany non-State law can be integrated into a contract by way of reference to substantive law instead of by way of choice of governing law.<sup>72</sup> The English Court of Appeal has refused to enforce Shari'ah principles.<sup>73</sup> Nevertheless, contracts under English law can be construed in a way that they do not contradict Shari'ah principles.<sup>74</sup>

Another question is whether the national private laws include efficient procedures to transfer a sufficient interest in the underlying property rights to the holders of Sukuk securities. The Anglo-American common law trust model allows for insolvency-proof equitable ownership interest of the beneficiaries ( holders of securities ) in the underlying real estate, whereas the issuing entity can retain the legal ownership.<sup>75</sup> It is very likely that UK courts would enforce a common law trust construed under English law, irrespective of the location of the property in

question. However, it should be noted that re-classification of „true sales“ to bankruptcy-remote vehicles by originators into „secured lending“ may be a risk under common law and specific Shari'ah issues ( claw back risk ).<sup>76</sup> On the other hand, it is likely that courts under EU civil law jurisdictions would follow the principle of *lex rei sitae*, i.e. the outcome would depend on the location of the property. For example, the common law trust is not established in the German civil law jurisdiction. The German Funding Register under § 1 ( 24 ) to ( 26 ) and §§ 22a to 22o of the German Banking Act ( KWG ), as far as applicable, provides for an insolvency-proof claim on the transfer of property rights, but not for a direct right in rem.<sup>77</sup> It

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70    □    Claxton Engineering Services Ltd. v. Txm Olaj-Es Gazkutato Kft [2011] EWHC 345.

71    □    Affaki, G. ( ed. ), Fadlallah, D. / Hascher, A. / Pezard, A. / Train, F-X., Proposal – Group on Governing Law and Dispute Resolution in Islamic Finance, 21st Sept. 2009; Follak, *ibid.* ( *supra* FN 68 ), pp.2.

72    □    Follak ( *supra* FN 68 ), p. 3.

73    □    Court of Appeal ( Civil Division ), 28th Jan. 2004 [2004] EWCA Civ. 19 [2004] 4 All ER 1072.

74    □    Blair, W., Keynote Address, Islamic Financial Services Board ( Ed. ), *Islamic Finance: Surveys on Global Legal Issues and Challenges*, Kuala Lumpur 2008, p. XX; Follak ( *supra* FN 68 ), P.2.

75    □    McMillen, M.J.T. / DeLorenzo, Sheik Yusuf Talal ( *supra* FN 52 ), pp. 143.

76    □    See above, chapter 7.

77    □    Follak, Klaus Peter, *The German Funding Register's Insolvency-proof Transfer of Cross-border Portfolios*, Thomson Reuters Westlaw Business Currents April 16, 2010, available online at [currents.westlawbusiness.com](http://currents.westlawbusiness.com). Germany is not a party to the Hague Trusts Convention.

would have to be discussed with Shari'ah scholars, whether this is sufficient.<sup>78</sup> Although France is a party to the Hague Trusts Convention, it has not entered into force, lacking ratification.<sup>79</sup> The French fiducie ( CC - Code Civil - Art. 2011 to 2031 ) grants a stronger position ( patrimoine d'affectation ), which might be classified as a right in rem sui generis.<sup>80</sup> Again, an in-depth analysis including Shari'ah scholars seems necessary.

As mentioned above ( chapter 5 ), access of Islamic Finance institutions to the Euro and USD markets is essential. In addition, Islamic Finance institutions will need assets which are eligible for liquidity reserves under the proposed Basel Committee ( „Basel III“ ) liquidity requirements. Even given full compliance with the above requirements and criteria, the ECB ( European Central Bank ) will have to take steps to accommodate Sukuk for access to liquidity. As for the current state, the ECB requires „debt instruments“ to have a fixed, unconditional principal amount even in the case of covered bank bonds. Otherwise, very restrictive ABS requirements would apply.<sup>81</sup>

Apart from these issues, several EU countries have taken measures to accommodate Islamic Finance and Sukuk:

In the **UK**, an officially supported Commission for the introduction of Islamic Finance has been established. Advanced legislation re. taxation<sup>82</sup> and banking regulation is in place. In particular, the definition of bonds includes Sukuk as „alternative bonds instruments“.<sup>83</sup> As a result, Sukuk listings are well-established at the London Exchanges.

In **France**, a Government Commission for the Introduction of Islamic Finance has been established as well.<sup>84</sup> Legislation re. taxation and banking regulation has been finalised. A tax-neutral regime is in place accommodating for Ijara, Murabaha and Sukuk structures, i.e. for bonds, cost-plus- financing, and leasing and construction industry forward

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78  The 2004 Sukuk of Saxony Anhalt was based on usufruct

79  Interestingly, this is also the case in respect of the USA.

80  On 17th September, 2009, the Senat voted to modify the fiducie framework to better accommodate Shari'ah issues.

81  ECB, The implementation of monetary policy in the euro area, chapter 6, 6.2.1 ( marketable assets ).

82  2007 Finance Act, facilitating Sukuk through favourable tax schemes, and 2009 Finance Act, providing for relief re. stamp duty and land tax in case of „finance sales“.

83  UK Financial Services and Markets Act 2000 Order 2010, Art. 77 A: the repayment of capital may be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income granted by them. The Malaysian ALIM transaction, e.g., would meet these requirements.

84  Affaki ( supra FN 71 ).

financing.<sup>85</sup> Further, the Autorite des Marches Francais ( AMF ) has published its position re. the admission of Sukuk to the regulated markets ( French NYSE/Euronext).<sup>86</sup> It seems worth mentioning that the University of Strasbourg offers diploma in Islamic Finance.

**Germany** is a different story. It is encouraging that the first issue of Sukuk by a government in the EU was launched by the German regional government of Saxony-Anhalt, based on an usufruct – Ijara structure.<sup>87</sup> The German banking supervision ( BaFin ) is supportive. A banking licence would be necessary for the conduct of banking business ( lending and / or deposit taking, § 1 (1) of the German Banking Act - KWG ) or for providing financial services as defined by § 1 (1a) KWG ( § 32 KWG ). The BaFin would classify Ijara in the form of a finance lease as financial service, as opposed to operational leases. Murabaha, however, as non-lending ( i.e. non-banking ) business. Sukuk are classified as financial instruments under § 1 (1a) KWG, the placement ( but not the issue itself ) of which would require a banking licence. However, it should be noted that Sukuk would not be classified as covered bonds ( „Pfandbriefe“ ). Nevertheless, further steps should be taken, in particular in respect of a tax-neutral regime for Islamic Finance products.

**Luxembourg's** exchange is a well-established Sukuk listings forum. Relaxed true sales“ to bankruptcy-remote vehicles by originators into „secured lending“ under common law ( claw back risk )documentation rules facilitating Sukuk were introduced as early as 2007, and the Treasury has published a circular on Murabaha and Sukuk in 2010.<sup>88</sup> Recently, the Luxembourg Central Bank hosted the 8th IFSB summit, where Governor Mersch stated that „Luxembourg stands as an interface between Islamic finance and global finance.“<sup>89</sup>

## 15. Outlook

The aftermath of the Credit Crisis might well be an era of collateralised funding on the basis of good quality assets, of which Sukuk deserve to have their share. It might be advisable to start the development of the necessary Sukuk framework as soon as possible to benefit from the new wave towards strengthening related mandatory requirements worldwide. It is encouraging that „various standard-setting organisations ( notably the IFSB, AAOIFI and IIFM ) have been working towards regulatory consolidation and harmonisation. Greater standardisation would enhance the valuation and efficient pricing of *sukuk* and improve secondary market liquidity within regulatory frameworks that are cast in a way to be flexible enough to adapt to the characteristics of new Islamic capital market securities while preserving universal standards of market supervision and financial surveillance.“<sup>90</sup> The World

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85 □ Bulletin Officiel des Impots no. 78, August 24 2010.

86 □ AMF position no. 2010-06, 227th October, 2010.

87 □ Standard & Poors press release 9th July, 2004.

88 □ Circular of 12th January, 2010.

89 □ Quoted by Parker, Mushtak, arabnews.com, May 16th, 2011.

90 □ Thani ( supra FN 7 ), p. 60.

Bank Group e.g., among other institutions, has „formally recognized Islamic finance and has designated it a priority area in their financial sector program.“<sup>91</sup>

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91 □ Indravati, Sri Muliani, Managing Director of the World Bank Group, quoted by Parker, Mushtak, arabnews.com, May 16th, 2011.