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## Islamic Finance Is Securitization's New Frontier

North & South American Contacts: Gary Kochubka, New York (1) 212-438-2514; gary\_kochubka@standardandpoors.com. Eric Hedman, CFA, New York (1) 212-438-2482; eric\_hedman@standardandpoors.com. Cristal E Jones, New York (1) 212-438-1128; cristal\_jones@standardandpoors.com  
European Contacts: Zeynep Adalan, London (44) 20-7176-3703; zeynep\_adalan@standardandpoors.com. Chris Such, London (44) 20-7176-3529; chris\_such@standardandpoors.com  
Asia-Pacific Contacts: Peter Eastham, Melbourne (61) 3-9631-2062; peter\_eastham@standardandpoors.com. Allan Redimerio, Singapore (65)-6239-6337; allan\_redimerio@standardandpoors.com

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With the first Islamic structured financings in the U.S. and Malaysia, yet another chapter has begun in the global securitization market. Their emergence, in both local and cross-border markets, shows great potential, especially as the assets being securitized begin to diversify and the market grows accustomed to the intricacies of the financing technique.

### How It Works

Islamic financing follows the principals of Shari'a (Islamic law). Shari'a has certain tenets, including:

- The prohibition on the payment of interest,
- The inability to engage in excessive speculation or risk-taking,
- Limitations on the use of the sale of financial assets and their use as collateral, and
- The exclusion from certain industries (such as those involving alcohol, gambling, or pork).

When Standard & Poor's analyzes and rates an Islamic note, or "sukuk," it bases its credit rating opinion on the transaction's compliance with applicable commercial law and its own credit risk criteria applicable to the jurisdiction and asset type. The rating, therefore, does not reflect the compliance of the transaction with Shari'a.

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### Originators See The Appeal

Islamic securitization is an appropriate financing technique for Islamic countries where originators are seeking new local funding sources. Rating Agency Malaysia reported that, as of March 2006, the banking sector had expanded its asset portfolio to over Malaysian ringgit 1 billion (approximately US\$274 billion), with Islamic assets representing 11.4% of the total. In the first half of 2006, two Islamic securitizations (US\$627 million) were issued in the local Malaysian market (see Rating Agency Malaysia's Islamic Finance Bulletin for April-June 2006). One deal securitized home financings (mortgages), and the other oil-palm plantations and palm-oil mills (whole business).

For 2007, we believe that the Gulf Cooperation Council (GCC) region has the largest potential for securitization. We've been fielding inquiries from Bahrain, Kuwait, United Arab Emirates, and Saudi Arabia. Asset types include residential mortgages as well as auto loans and consumer finance. We expect the types of assets to become more diversified as the market gets used to

securitization. As did Malaysia, the GCC market may use both Islamic and non-Islamic securitizations to finance the asset pools.

Islamic securitization is also appealing because it's not restricted to Islamic countries (predominately Asian and Middle Eastern countries). In 2006, Standard & Poor's rated the first U.S. Islamic securitization in the form of sukuk, East Cameron Gas Co.'s US\$165.7 million investment trust certificates. The rating solely addressed the investors' likelihood of receiving the scheduled payment of sukuk return and redemption. The assets were overriding royalty interests in oil and gas production from properties located in the Gulf of Mexico, 20 miles off the shore of Louisiana.

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### **The Bottom Line**

In whatever country Islamic securitization is undertaken, it will increase the availability of capital and reduce financing costs for originators. It can replenish the funding sources for institutions and give investors tailor-made products that meet their portfolio requirements, including diversification and risk reduction. We expect to see more of these transactions as more securitizable assets are generated in Islamic countries and elsewhere.

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### **For More Information. . .**

The following articles are available on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com):

- " Gulf Region Takes First Steps Towards An Active Structured Finance Market ," published Sept. 6, 2006;
- " New Issue: East Cameron Gas Co. ," published Aug. 10, 2006;
- " Rating Sukuk--How Rating Methodologies Apply to Islamic Debt Financing ," published Sept. 15, 2003; and
- " Two Aspects Of Rating Sukuk: Sharia Compliance And Transaction Security ," published Jan. 12, 2006.

For more information on Islamic securitization in Malaysia, see Rating Agency Malaysia's article titled "Asset Securitisation in the Context of the Malaysian Islamic Capital Markets."

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