

Asset-backed sukuk: Is the time right for true securitisation?

The challenges and untapped potential of asset-backed sukuk



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In the 'conventional' finance space, asset-backed financings have proved a successful method of funding social and civil infrastructure. However, in Islamic finance, asset-backed sukuk have not yet taken off. **Debashis Dey** and **Claudio Medeossi** of global law firm White & Case examine why.

The majority of sukuk in the international markets are asset-based, making them dependent on the creditworthiness of the sponsor, rather than the performance of the assets. The concept of securitisation of assets—limited in recourse solely by the performance of the assets underpinning them—has, to date, only enjoyed limited application in the Islamic finance space.

For asset-backed sukuk to succeed, investors have to go beyond simply looking at the credit standing of government and quasi-governmental entities (the sponsors) and start looking at the actual cash flow and exposure to asset values.

One of the most fundamental factors that could determine the popularity of asset-backed sukuk in the Middle East is liquidity. During times of high oil prices, governments have deposited surplus cash with banks who then lend at very competitive rates in the market. Since late 2014, however, low oil prices have prompted governments to withdraw deposits, appearing to lessen regional liquidity.

Markets have changed as liquidity has tightened. Domestic liquidity is still available in the region, but concentration limits and the duration of

funding will be an issue for regional banks. This has opened an opportunity to identify a market segment where asset-backed sukuk may fill the need.

Open door for asset-backed sukuk?

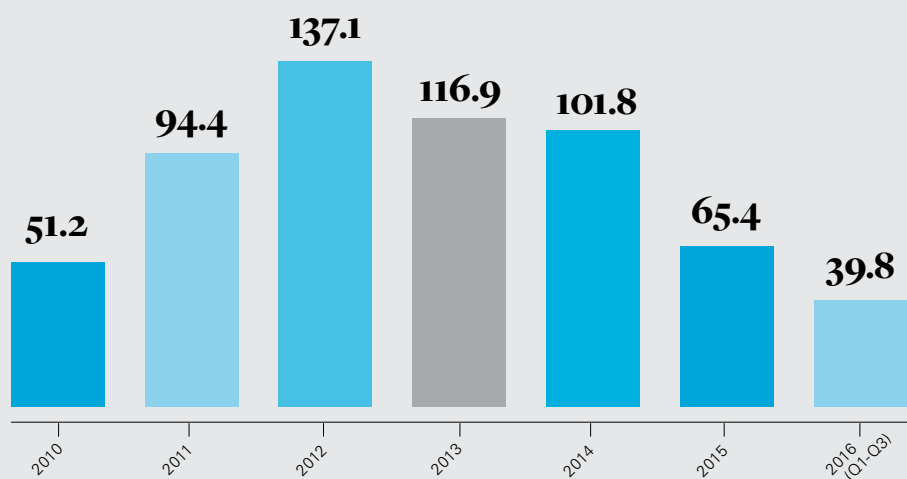
Middle Eastern governments are increasingly reluctant to fund projects solely with their own financial resources in light of lower oil revenues and a growing perception that state-held financial reserves should

be preserved for future generations.

This might suggest a strong rationale for asset-backed sukuk. The question is, is there space in the market for different products and the demand to back that up? More challenging still, is there a market for long-term products targeted at institutional investors that could help provide alternative funding sources?

While a market exists that targets Islamic investors, and which is broadly

Global sukuk issuance historical trend (US\$bn)



Source: Thomson Reuters

Asset-backed v asset-based	Asset-backed (true securitisation)	Asset-based (non-securitisation)
Credit risk	Assets	Company balance sheet
Process	Limited recourse securitisation of tangible assets	No recourse to assets
Characterisation	Equity risk	Fixed-income risk
Sources of payment	Income/capital generated by the underlying assets	The company's cash flows arising off of the assets
Sukuk holder's ownership	Legal ownership with right to dispose of underlying assets	Contractual ownership with no right to dispose of the underlying assets
Recourse	Typically, sukuk holders do not have recourse to the originator (recourse only to underlying assets)	Typically, sukuk holders do have recourse to the obligor (originator) if there is a shortfall in payments

Source: White & Case

similar to the unsecured international Eurobond market, there are structural obstacles currently preventing asset-backed sukuk from playing a crucial role in broadening the investment pool and assisting in the financing of projects to which governments are either unwilling or unable to commit.

For example, there is a need for coherent political direction. In Western Europe, for instance, governments have provided the support for the development of public-private partnership (PPP) arrangements. When governments decide not to deploy funds for certain types of projects, this opens the way for PPP.

In the Middle East, it would mean creating an operating framework in each country where the role of the

state is agreed by all parties, and that political interference must be limited, in order to be able to plan for the long term. This all hinges on greater certainty in the legal system and how courts apply judgments, in order to be able to ring-fence cash flows both prior to and after any default.

Analysing cash flows

As important as political stability and a robust investment climate is the need to attract a different investor base by expanding beyond the local financial institutions and the sponsor-focused credit analyses they prefer.

For the purpose of asset-backed sukuk, investment banks structuring the transactions need to consider how cash flow arising from the assets can be monitored and reported. This

What is the difference?

Sukuk are a form of Shari'ah-compliant fixed-income capital markets instruments that represent an interest in an underlying funding arrangement structured according to Islamic finance norms. The holder is entitled to a proportionate share of the returns generated by such arrangement and, at a defined future date, the return of the capital. Whereas in an asset-based sukuk structure, the overriding reliance of investors is on the credit strength of the obligor rather than the underlying assets, in an asset-backed sukuk, the profit return and return of capital are ultimately based on the assets. Investors can be expected to want to assess the value of the assets themselves.

would also require sponsors of transactions to be better organised in providing this data in relation to the specific projects or assets. In contrast, under the existing asset-based sukuk methodology, banks or investors analyse the balance sheet of the sponsor and largely ignore asset performance reporting. The current approach, therefore, may involve an understanding of the sponsor's financial balance sheet, but tends to ignore the assets—the Shari'ah-compliant components—and encourages judgments based largely on the existing balance sheet and, if applicable, the ratings regarding the sponsor. It also seems that current sukuk investors in the market do not have (or do not wish to create) the internal or external expertise to analyse collateral behind the security and, at the moment, there seems to be a lack of regional non-bank investors who can analyse cash flow effectively.

More sophisticated analytical modelling and instruments are needed to assess the value of assets and cash flows. In Western Europe, rating agencies work together with banks structuring the securitisation to ensure that the structures enable cash flows to be ring-fenced from assets that are



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themselves ring-fenced, for the purpose of establishing the value of future cash flow that can be produced.

While this process has not typically been the case for sukuk transactions in the Middle East, the process is essential for successful asset-backed financing. Further, the very process of ring-fencing assets for the benefit of investors is a core principle of Islamic finance.

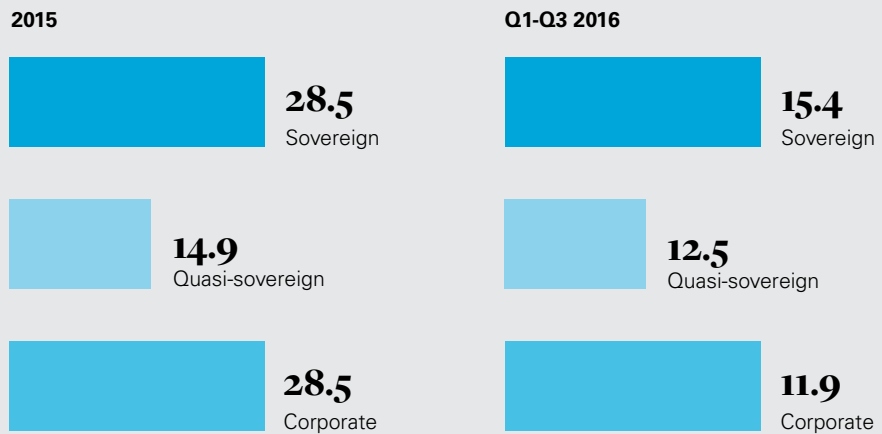
The need for a new kind of investor

For progress to be made, various authorities within MENA governments will need to consider how to start attracting investors interested in long-term returns. Currently, this is the preserve of the multinational institutions. In the Middle East, those entities with the analytical instruments to understand cash flow tend to be specialist Islamic finance institutions or private funds.

Beyond that, it is difficult to locate a large regional investor base willing to take on greater than 10-year investments. This comes back again to the question of where the markets are going in terms of development. If it is the case that the Gulf's sovereign wealth funds are no longer buying trophy assets abroad and are starting to buy assets locally, then there's clearly potential. But the question remains whether they will be prepared

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The broader geopolitical challenges facing the region may also help build support for asset-backed sukuk

Global sukuk by issuer (US\$bn)



Source: Thomson Reuters

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to do this in an Islamic format and take the risk of asset performance rather than equity investment.

In the case of a major regional entity such as Saudi Arabia's Public Investment Fund (PIF), which receives government funding to invest directly in projects, often it is only likely to undertake an investment if it is in a true 'arm's-length' manner. In this way, a tradeable asset-backed instrument such as a sukuk is provided, which enables it to demonstrate that it has sukuk instruments on its balance sheet—and not a direct investment in assets that might be more difficult to document and structure (given that it would be an equity investment).

If the PIF were to demand that instruments be designed in such a way, it would be easier to imagine sovereign wealth funds from other Gulf states looking for a piece of that market—especially if it provides a means of taking exposure on the country's fundamentals. It could be done, but the market is yet to see if an investor is willing to step up to the plate and do it properly.

Some near-term opportunities

The broader geopolitical challenges facing the region may also—counterintuitively perhaps—help build support for asset-backed sukuk. Major regional conflicts portend a potentially gargantuan reconstruction effort. The funding for this will surely have to come from multilateral and sovereign funds.

Those funds will expect some return over the long term, and this could create a framework that could allow for a long-term funding of infrastructure needs. But to get to a certain kind of structure in the market on the kind of scale that is required, the issue of political stability has to be addressed.

In the meantime, asset-backed products could develop in relation to more bespoke sectors. For example, once completed, projects often require refinancing, often backed by income generated by the project. This is an area with big potential for asset-backed sukuk. A project that is substantially in the completion phase is far more likely to succeed with an asset-backed sukuk than a greenfield one.

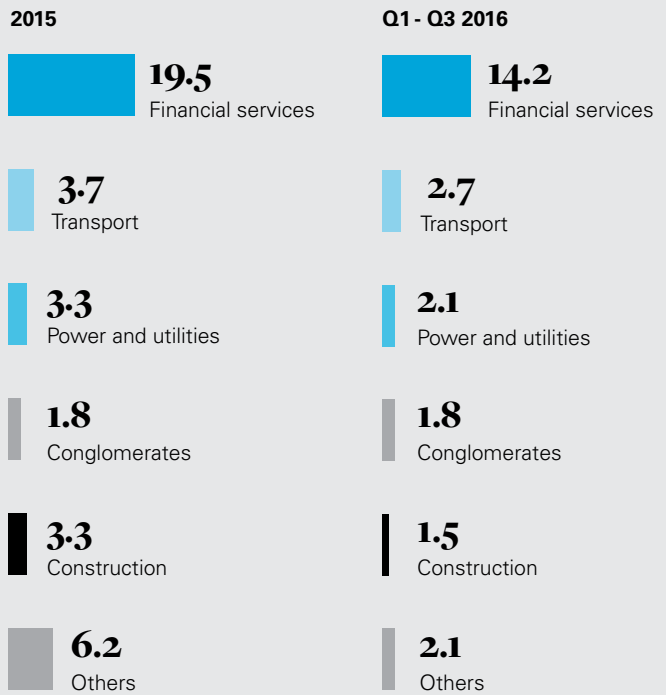


Asset-backed sukuk will most likely be seen in sectors where there are fewer political constraints

Above all, there's a compelling need to move from theoretical discussions to a more concrete analysis of which sectors are more likely to be affected and what kind of interest at the investor level could exist.

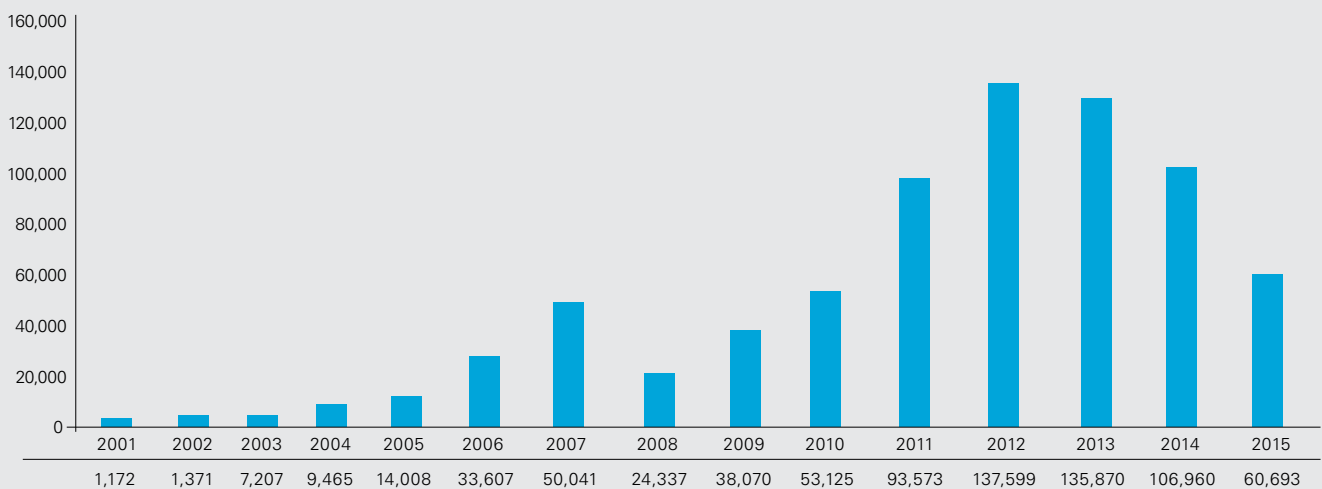
Asset-backed sukuk will only emerge gradually and will most likely be seen in sectors where there are fewer political constraints. Still, the prize is substantial. Investors, attracted by the robust demographic characteristics of the region, stand to benefit from gaining access to tradeable, Shari'ah-compliant instruments that grant them exposure to that demographic.

Global sukuk by sector (US\$bn)



Source: Thomson Reuters

Total global sukuk issuances (Jan 2001 – Dec 2015; US\$bn)



Source: IIFM Sukuk Database

Total global sukuk issuance: 767,099

Debashis Dey

Partner, Dubai

T +971 4 381 6202

T +44 20 7532 1722

E debashis.dey@whitecase.com

Claudio Medeossi

Counsel, Dubai

T +971 4 381 6208

E claudio.medeossi@whitecase.com

Greg Pospodinis

Associate, Dubai

T +971 4 381 6209

E greg.pospodinis@whitecase.com

Xuan Jin

Associate, Dubai

T +971 4 381 6214

E xuan.jin@whitecase.com

whitecase.com

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