

Legal and Regulatory Requirements for a Successful Introduction of Real Estate Based Sukuk

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Abstract

Many countries are trying to catch up on Sukuk legislation and regulation. This coincides with growing demand for safe assets which fulfil important functions in respect of central bank liquidity management, prudential regulation, and for institutional investors such as pension funds. So far, the focus was frequently on clearing impediments based on tax issues and stamp duties. But that is not enough. A comprehensive and reliable legal basis is key to gaining investors' confidence, including certainty of property rights, sound and solid securities, trading and exchanges regulation, certainty in respect of cross-border transactions, as well as reliable Shari'ah standards.

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1. Introduction

Sukuk are instruments where the interest in assets (in this case real estate) 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. In addition, 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 (for definitions see Alsyyed, 2009; Thani and Othman, 2011, chapter 18). Islamic finance instruments and in particular Sukuk have experienced significant growth during the last few years, with only minor discontinuities caused by the credit crisis. In general, banks applying the principles of Islamic Finance have performed fairly well during the crisis, which has been demonstrated by Follak (2009) at the International Law Association Committee on International Monetary Law (MOCOMILA) Meeting in Kuala Lumpur, hosted in September 2009 by the Bank Negara Malaysia. Since 2007, the global outstanding Sukuk volume has more than doubled from USD 97bn (UK HM Treasury, 2008, p.9) to more than 200bn in 2010. The global Sukuk issue in the first quarter of 2012 - USD 43.3bn – has nearly reached the total of 2010 - USD 47.78bn - and should well exceed the 2011 volume - USD 85.1bn (Economist, 2012; RAM, 2012, pp.1).

2. Economic Needs

There is a world-wide trend to establish real estate based covered securities which have an old tradition in Europe and are now expanding globally (e.g. Australia, Canada, China, Hong Kong, New Zealand, Singapore, USA), particularly in Asia, where they can reduce reliance on short-term local currency retail deposits (Armstrong and Soh, 2012). These developments are coinciding with growing demand for safe assets which fulfil important functions for various types of investors: managing their inherent maturity mismatches, preferential regulatory treatment, collateral for repo and derivatives transactions, securities benchmarking and, last but not least, preserve market value to meet long-term liabilities of insurance companies and pension funds (IMF, 2012, p.9). “ With a view to fundamental revisions of prudential regulations in respect of capital and liquidity requirements, banks have intrinsic incentives to hold safe assets to manage liquidity and solvency risks” (IMF, 2012, p.11 and pp.15). This might increase the demand for safe assets by some 2tn to 4tn USD worldwide (IMF, 2012, p.19). Further, safe assets are integral part of central banks’ liquidity operations in response of the Credit Crisis (IMF, 2012, p.8).

Real estate based Sukuk as the Shari’ah-compliant alternative of covered bonds will benefit from these developments; a comparative study on these two financial instruments has been presented at the 8th International Conference on Islamic Economics and Finance in Qatar by Follak (2011).

The IFSB (Islamic Financial Services Board, the international regulatory body for Islamic financial institutions) has already adopted Basel III compliant liquidity requirements, forcing Islamic financial institutions to hold safe and liquid assets. Sukuk are also emerging as a new asset class for investors, since asset-backed / based instruments provide relative capital protection and predictable returns to investors, while in addition, a near-absence of long term financing tools and a growing importance of long-term capital projects launched in the region has also increased the attractiveness of sukuk (MENAFN, 2011). The increasing volume of Sukuk also qualifies these instruments for the establishment of a global wholesale funding tool

for Shari'ah compliant finance of real estate, including residential property, as well as for the creation 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 (Follak, 2010). Expanding the scope of financing for home purchases will form a critical component of housing reform measures in MENA countries and Asia. The World Bank Group has “formally recognized Islamic finance and has designated it a priority area in their financial sector program.” (Indravati, 2011)

3. Legal Basis: Contractual or Statutory?

The related legal basis can be statutory, i.e. prescribed by law, decrees etc. or contractual i.e. based on individual documentation only.

Purely individual documentation, in which all of the terms and conditions are defined in the issue-specific legal framework (IMF, 2009, p.90) – examples are recent Sukuk issues, including the very successful Cagamas (National Mortgage Corporation of Malaysia) programme launched in 2010, as well as non-regulated “structured” Mortgage Backed Securities - gives a maximum of flexibility. In particular, the Cagamas issue, benefiting from a AAA rating by the Rating Services Berhad, Kuala Lumpur (RAM), was a landmark; it has been described in detail by RAM Ratings (2010). The problems are fragmented markets. In addition, the outcome of legal disputes may be uncertain – a disadvantage aggravated by the fact that not many documentations have been tried in court cases.

Statutory systems, where substantial items are prescribed by law, have a proven competitive edge, in particular in respect of underlying asset quality. This can be demonstrated by a USD 3tn European market – approximately 40% of the EU GDP – with a majority of covered bonds issued under “special law” frameworks ensuring proper recourse and uniform standards for product structures and cover pool credit quality (IMF, 2009, p.90).

Basically, legal standardisation and simplification increases transparency and “...should encourage standardized building blocks for securitized products. It would also be useful if some standardization could be imposed on the underlying assets to maintain higher quality pools or at least verifiable pools” (IMF, 2009, p.100). The result is the above-mentioned global wave of statutory covered bonds. Even in the USA, traditionally the country of contractual MBSes, explicit legislation is being prepared (Draft United States Covered Bond Act, 2011). Based on the current situation lacking explicit regulation, the Standard & Poors uplift allowance on legislation for the US is fairly low (3 – 5 notches) versus 5 – 7 for Germany and France.

4. Certainty of Property Rights

The certainty of property rights under the governing jurisdiction 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.” (Skafianakis et al., 2011, p.11). The IMF Global Financial Stability Report states that “Many emerging markets are still in the process of developing well-functioning financial systems, which are characterized by sound legal institutions and adequate property rights.”(IMF, 2012, p.32). Therefore, e.g., the methodology of rating agencies caters for jurisdiction-based rating uplifts.

Basic legal requirements are as follows:

- Clearly defined and enforceable property rights covering ownership, transfer and security (collateral) rights.
- Property rights must be unambiguously allocated to owners and beneficiaries of security rights and easements. This can be achieved by official registers established in public faith.

- 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.
- Clearly defined and enforceable rights in respect of assets held in trust.
- 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 countries 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 (e.g. by the Center of Legal Competence, Vienna) would be very desirable for practitioners and academics as well. There are sophisticated private respectively common law systems in place in countries such as Malaysia. 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.”(Skafianakis et al., 2011, p.11).

5. Sound Sukuk Securities Legislation and Regulation

The IMF Financial Stability Report (IMF, 2012, press release, p.2 and summary, p.1) states that “The private production of safe assets...would be supported by a recovery of securitization on a sounder footing, and well-conceived and regulated covered bond structures... To ensure that such products fulfil their safety role, there is a need to introduce: (1) intensive supervision, (2) better incentives for issuers (aligning issuer’s compensation with the longer-term performance of the created securities), (3) a robust legal framework and (4) improved public

disclosure to ensure that securitized products are well understood and market participants have the resources and information to price and manage the risks. Well-conceived and regulated covered bond structures of mortgages (with overcollateralization and the ability to replace impaired loans) are a good example...”(IMF, 2012, pp.35). Although the ability to replace impaired loans might be hard to achieve with Shari’ah-compliant structured, because it might be interpreted as an originator’s guarantee (RAM Ratings, 2011, pp.4). These requirements could be broadly met by sound legislation.

Conventional Covered Bond structures cannot be applied on a one-to-one basis to Shari’ah-compliant Sukuk, because under many conventional regimes “...covered bond issuers retain full exposure to the credit risk associated with the underlying assets, rather than passing them on to investors...”(IMF, 2009, p.80). Nevertheless, following the example of successfully established Covered Bond frameworks, the general soundness of Sukuk securities-related legislation requires

- a clearly defined and enforceable legal basis for securities, transfer of claims and rights, and securitisation in general;
- clearly defined and enforceable corporate law in respect of issuing entities;
- a clearly defined and enforceable legal basis for insolvency and insolvency remoteness of issuing entities.

Stringent regulation in respect of underlying real estate pools is essential:

1. Eligibility and quality of underlying assets: real estate and/or related revenues (e.g. ijara or rental income), subject to certain risk restrictions (“loan-to-value” ceilings or “over-collateralisation”). How the latter requirement can be achieved applying Shari’ah-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. Apart from residential and commercial property, claims against public-sector entities would be possible, to enable Public Private Partnership finance for public-

sector properties such as hospitals. The Ijara Sukuk issued in 2004 by the German regional government of Saxony-Anhalt, listed at the Luxembourg Stock exchange (Standard & Poors, 2004), is an example. Further possibilities could be aircraft and shipping finance (Matthews, 2010, p.15).

2. Insolvency remoteness of the underlying real estate pools: clear and separate insolvency procedures for underlying pool assets. If the issuer and / or the originator is insolvent, pool assets should be used exclusively to satisfy the claims of Sukuk holders. “ In any case, potential covered bond investors will require certainty that they will not be denied access to the cover pool assets in the event of ... failure.”(IMF, 2009, p.108). In merely contractual structures lacking cover pool-specific legislation, “ ...there are potential challenges which could threaten the priority of bondholders with respect to the cover assets.”(Mackie, 2011). 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 has been considering specific legislation (Mackie, 2011). With a view to Sukuk, specific legislation seems even more advisable, because “...insolvency procedures subject to Shari’ah 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.”(Thani, 2010, p.60).
3. Regulation for the orderly continuation of the underlying real estate 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. This issue is also being discussed in the above-mentioned US initiative. Further, the appointment of a specific administrator with clear powers and responsibilities after the issuer’s default would be helpful.

4. Ongoing governmental supervision of the issuing entity and the underlying real estate pool (including on-site assessments).

6. Sound Legislation and Regulation in Respect of Trading and Exchanges

The IMF Financial Stability Report (IMF, 2012, press release p.2, summary p.1, and p. 32) states that “The build-up of the capacity of emerging economies to issue their own safe assets via the improvement of domestic financial infrastructure would also alleviate the imbalances in the global safe asset markets... The high demand for safe assets produced by advanced economies has been, in part, supported by the inability of emerging market issuers to contribute to the global supply of safe assets.” Although Asian banks are flush with local currency retail deposits, the establishment of sound capital market structures is essential. “The absence of market infrastructures on par with those of advanced economies means that governments, corporations and individuals will continue to have difficulties pledging future cash flows associated with the issuance of local debt securities. Such limitations curb the supply of assets in local capital markets and limit the development of liquid financial markets, forcing some to seek assets outside their country, with attendant currency risks.”(IMF, 2012, p.32). In emerging markets, ongoing improvement in domestic financial infrastructure – including legal certainty, clearing and settlement systems, and transparent and regular issuance procedures – will support further deepening of local...markets.”(IMF, 2012, p.32 and pp.35; see in general Gray et al., 2011, and Goswami et al., 2011).

In economic terms, 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 impact on pricing;
- tightness of bid-ask spreads to cater for cost-efficient trading;

- ability to absorb random shocks in respect of day-to-day price volatility (Goswami et al., 2011, p.13).

Sukuk and bond markets in the MENA region and Asia are still confronted with a few specific deficiencies. As less liquid markets, they are characterised by a narrow investor base, insufficient infrastructure, low market transparency, and lack of timely information (Goswami et al., 2011, p.13).

Against this background, specific requirements in respect of legislation and regulation can be identified:

- strictly regulated exchanges with a robust legal framework in respect of trading and market supervision;
- effective trading platforms, enhanced by market-making abilities of primary dealers.
- reliable depository, settlement and payment systems, including central clearing counterparties;
- transparency and timely market information; introduction of appropriate pricing benchmarks and hedging instruments;
- improving corporate governance;
- introducing robust frameworks for asset-backed securitisation;
- abolishing capital controls for foreign investors.

7. Certainty in Respect of Cross-Border Transactions

There is an emerging market of cross-border Sukuk, e.g. the above-mentioned (chapter 3) Malaysian Cagemas ALIM transaction, or the Kuwaiti Gulf Investment Corporation's Wakala Sukuk (Halawi, 2011). In cross-border transactions, three jurisdictions are involved:

- 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.

For a comparative summary of national securities laws, see McMillen (2008).

Cross-border harmonisation of related private law issues is not realistic and has not been tackled even 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 (Gray et al., 2011, p.4). "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." (Anwar, 2009). Explicit legislation is required regarding:

- International and conflicting insolvency law;
- International and conflicting private law;
- enforcement of foreign judgements and arbitration
- choice of law.

8. Standard-setting Bodies for Shari'ah Issues

The 8th IFSB summit in Luxembourg, May 2011, came to the conclusion 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 interpretation of Shariah rulings across various jurisdictions; the lack of standard

documentation which in turn contribute to the high cost of transactions...” (Indrawati, 2011). 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. 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 (McMillen and DeLorenzo, 2008, pp.143). Further, scholars in a number of Islamic jurisdictions state that murabaha debt cannot be securitised (Abdel-Khaleq and Richardson, 2007, p.412). The prevailing view of Malaysian scholars differs, as long as the underlying receivable is connected to a true trade transaction (Abdel-Khaleq and Richardson, 2007, p.412). In an alternative 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 is paid toward ownership until the customer owns 100% of the property; at that time the title passes to the lessor (Abdel-Khaleq and Richardson, 2007, p.412).

In general, Shari’ah-compliant sukukisation of large property finance portfolios using Wakala bi Istithmar structures 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 (RAM Ratings, August 2010). A second example is the Gulf Investment Corporation sukuk (residence in Kuwait, issue in Malaysia) in 2011. Nevertheless, “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 Shari’ah compliance may challenge the legal status and restitution interest of investors.”

(Thani, 2010, p.60). Many countries have introduced, or are preparing frameworks for a Sukuk-friendly environment: Australia (restricted to a number of Federal States), Egypt, France, Hong

Kong, Japan, Luxembourg, Malaysia, Nigeria, Senegal, South Korea, Thailand, Turkey, and the UK, to name a few. However, the focus was on clearing impediments based on tax issues and stamp duties. Besides Malaysia, few Muslim countries have issued specific and comprehensive legislation on Islamic Finance, e.g. Pakistan, Iran, Turkey and the UAE.

Whereas Malaysia has extended specific legislation based on the dualism of civil and Shari'ah law already in place, the awareness of related problems is increasing, and there are many encouraging initiatives implemented or under way:

- The foundations of Sukuk standards have been laid by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI): Standard for Investment Sukuk, Art. 2 and 5 ½, as clarified following critical considerations by Mufti Muhammad Taqi Usmani.
- An IFSB task force has been established to publish recommendations for standard Sukuk structures.
- The establishment of the International Islamic Liquidity Management Corporation (IILM) could be even compared with the importance of the European Central Bank (ECB) for the EU financial markets.
- Agreements of mutual recognition regarding common standards are in place, e.g. between the GCC and Malaysia.
- An Islamic Interbank Benchmark Rate (IIBR) has been introduced by Reuters as an alternative to conventional interest-based benchmarks, using an average expected return on Shari'ah-compliant instruments.

9. Outlook

Many jurisdictions are trying to catch up on Sukuk legislation and regulation. Hong Kong, e.g., launched a two-month consultation on 29th March 2012. Lack of Islamic bond-friendly legislation has hindered the creation of a Sukuk market for a certain time in many countries. In

particular, amendments in the area of profit tax, property tax and stamp duties are being widely tackled. But this is not enough. “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.” (Goswami and Sharma, 2011, p.26). In response to a consultation paper on Covered Bond issuance published by the Monetary Authority of Singapore (2012), the rating agency Fitch laid down the basic requirements of rating agencies: liquidity protection, measures to ensure continuation of payments to bondholders in the aftermath of the issuer’s default, public disclosure requirements for coverpools and covered bonds, appointment of a specific administrator with clear powers and responsibilities after the issuer’s default. The rating agency Standard & Poors stated :”So far, Asia-Pacific jurisdictions are taking a ‘legislative light’ approach to covered bond regimes, generally benefiting from existing legal frameworks that support structured finance transactions” (Standard & Poors, 2012), continuing that many stakeholders see legislation as key to unlocking investors’ confidence in new covered bond markets. These remarks can be fully applied to Sukuk.

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