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الإسلامية الدولية
International Islamic
Financial Market

Use of Sukuk/Islamic Securities as Collateral

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INTRODUCTION

- In tandem with the widening international outreach, there has been a steady increase in product innovation in Islamic finance. The product range has now expanded into an extensive spectrum of retail financing and sophisticated financial products such as Islamic liquidity management instruments etc. There is no doubt that the dynamism of the Islamic Law (i.e. *Shari'ah*) has been an important driving force in contributing to the accelerated pace of innovation in Islamic finance.
- Liquidity management instrument is an instrument used to ensure that the liquidity of financial institutions is at its best level same is true for investors who invest in Islamic Securities at Stock Exchanges.
- IIFM based on its Consultative Paper "Alternate to Repo" published in 2010 has published a Standard "Master Agreement For Collateralized Murabahah" with aim to provide alternate liquidity management tool where idle Sukuk or Islamic Equities can be used as a collateral

- The conventional repo as a credit-risk mitigation instrument cannot be replicated in Islamic finance because of its non *Shari'ah* compliance features such as buying and selling with the same counterparty,   re-hypothecation, etc. that is why IIFM published its global MCMA Standard in 2014 which is currently used by a number of institutions in various jurisdictions

- Even though repo is a collateralized transaction, but the seller may fail to repurchase the securities sold at the maturity date. Consequently, the buyer may keep the securities, and liquidate the securities in order to recover the cash lent. These securities, however, may have lost value since the outset of the transaction as the securities are subject to market movements. To mitigate this risk, repos are often over-collateralized as well as being subject to daily mark-to-market with margin calls while the credit exposure is maintained with an agreed threshold.

1. *RAHN* i.e. COLLATERAL

- In the context of Islamic finance, *Rahn* or collateral refers to a contract of security. And conceptually, it means requiring a particular asset to be made as security for a financing or loan so that in the event of default by the financing receiver i.e. debtor, the financing or the debt may be satisfied out of the value of the security or the financed asset.

- In short it is an arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed of in the event of a default.

- In normal practice, credit facility offered by an Islamic financial institution, either under sale based or other possible methods will be secured by appropriate collateral with adequate value. Assets including shares and investment certificates etc. are forms of security that are accepted by the Islamic financial institution throughout a particular financing or debt tenure.

2. USE OF *SUKUK* AS COLLATERAL

- According to the AAOIFI *Shari'a* Standards: (*Shari'a* Standard No. 39, Statement 4 - Mortgage of Financial Papers and *Sukook*, Page 701)

- "It is permissible to mortgage the financial papers and *sukook* which can be issued and transacted according to *Shari'a*, such as Islamic *sukook* and shares of Islamic financial institutions. The shares of the companies whose original activities are permissible can also be added to this category" (see *Shari'a* Standard No.21, on Financial Papers: Shares and Bonds, item 3/4).

- "It is permissible to mortgage usufruct-based *sukook* which represent common shares in the usufructs of specific assets, or assets in the form of a specific indebtedness. This should be taken with due consideration to *Shari'a* Standard No.17, on Investment *Sukook*, items 5/1/5/2".

Continued

- “It is impermissible to mortgage the financial papers and *sukook* that should not be issued or transacted according to *Shari’a*, such as interest-based bonds, preference shares and enjoyment shares” (see *Shari’a* Standard No. 21, on Financial papers: Shares and Bonds, items 2/6 and 2/7). “Such financial papers include also traditional investment certificates, certificates of traditional investment deposits and shares of the companies that pursue *Shari’a*-banned activities like manufacturing of alcohols, swine trade and dealing in *riba*” (see *Shari’a* Standard No. 21, on Financial papers: Shares and Bonds, item 2/1 and *Shari’a* Standard No. 14, on Documentary Credits, items 3/4/1 and 3/4/2). “Among these financial papers also are shares of traditional financial institutions, shares of traditional financial companies, shares of traditional insurance companies and shares of companies which originally pursue permissible activities, yet *riba*-based and other prohibited dealings constitute a predominant part of their activities”.

Key Considerations

- **Counterparts:** The counter parties could be an Islamic bank or Central Bank (CB), or Banks , or any Financial Institution, Takaful Co, Insurance Co, Funds, Pension Funds, Corporates etc
- **Collateral Type:** In addition to *Sukuk*, other *Shari'ah* compliant securities which could be used as collateral, Listed Equities and Funds
- **Clearing System Consideration:** *Sukuk* could be international clearing house based as well as domestic *Sukuk and for Equities domestic clearing house and custodians*
- **Use of Collateral Re-Hypothecation**: i.e. *Sukuk* use by CB,FI and Corporate – probably FI and Corporate are likely to use *Sukuk* provided as collateral as compared to CB
- **Taking Security:**

a) For the proposed structures to be practical, it would need to be possible to take security over the securities quickly, effectively and robustly

b) Ability to collateralize more than one transaction in both direction

c) Issues concerning netting, set-off's, and enforceability

Continued

Key Considerations

- **Margin Maintenance:** The margin maintenance methodology needs to be quick, effective and robust. Easiest form would be to add or return *Sukuk* depending on collateral level agreement

- **Default Remedy :**

a) In event of non-payment of margin,
b) Non-payment of Debt,
c) Non delivery of Collateral

- **Governing Law**: up to the counter parties to decide

- **Accounting Treatment for Collateral**

a) Recognition as what?
b) Pledge?
c) Impact of Collateralization on Negative Pledge on existing financing
d) Use of *Sukuk* held in Hold to Maturity Book as collateral
e) Corporate Actions

Continued

Key Considerations

Dealing with the Collateral Asset and the *Shari'ah* Standpoint

- **Re–hypothecation or Re-use of collateral by collateral taker** (a major discussion point)

  In conventional repo, the buyer has an ability to make use of the repo's securities in its own business, which adds to the economic value of the repo to the buyer. However, this is not permitted by *Shari'ah*. Moreover, re-hypothecation leads to speculative activities and is not desirable from regulatory perspective also..

- **Appreciation of the market value of a collateralized asset**

  The appreciation of the market value of a collateral asset may lead to a situation where the security value is more than enough to cover the financing amount compared to when it was initially charged. In addition, consistent payment of debt by the debtor in accordance to the agreed schedule will gradually reduce the amount of outstanding debt and will consequently lead to the security in excess of the required security coverage rate. In this situation, the owner of the collateral asset may seek to charge the asset for security in another transaction (second charge) by way of charging the value that is in excess of the required first charge amount.

Key Considerations

- **Sale of collateralized asset in the event of default by financing receiver to pay the financing amount to financier**

  The permissibility of sale or liquidation of security in the event of default whereby the financing receiver has failed to pay the financing amount to the financier within the agreed period is in line with the objectives and basic features of charge in Islam. The financier may stipulate a condition requesting the financing receiver to appoint the former or a specified individual to sell the collateralized asset in order to settle the outstanding financing amount without the need to refer to court. In addition, the financier is allowed to request for the sale of the collateralized asset for the settlement of overdue financing amount. Any excess from the sale price shall be returned to the financing receiver since it is part of the charge.

  In short, in the event of a default whereby the financing receiver has defaulted in paying the financing amount to the financier within the agreed term, the financier may sell the charged securities to redeem the financing amount due by the financing receiver. However, the financier shall return any excess of the securities' value should the value exceeds the financing amount.

Key Considerations

- **Profit accrued from collateralized asset throughout the tenure**

  From the *Shari'ah* standpoint the owner of collateralized asset as the financing receiver in a collateral contract is entitled to any profit accrued from the collateralized asset throughout the contract tenure because the collateral contract does not involve transfer of ownership of the collateralized asset from the collateral giver to the receiver. Hence, any profit including dividends as well as rights or bonus issues accrued from collateralized asset throughout the contract tenure belongs to the owner of the security which is the financing receiver.

Key Considerations

- The collateral need to be tradable and could be Sukuk or listed Islamic Equities
- The pledged collateral will be the beneficial property of the Pledgor
- The profit or dividend can be used to either partly pay the financing or to use it for rebate in case the parties mutually agree for rebate in case of early termination of Murabaha contract. Operationally Custodian or collateral management service provider will perform this function
- On the collateral management and custody services, following two issues need to be agreed at the time of finalizing the arrangement:

A. Use of independent third party for collateral management & Custody services that is referred as Tri Party Services

B. The International Sukuk are mostly in custody of International Collateral Management Service Providers and they could act as an independent third party. An institution/bank providing collateral & custody services i.e. arrangement between the two transacting parties with no tri-party arrangement where one of them (the bank) provides collateral and custody services.

Key Considerations

- In case of the domestic securities including Sukuk, most likely the Custody and Collateral management services will be performed/provided by the collateral taker.

➢ **The Shariah view:**

i. **In case of an independent third party (Tri- Party Service) providing the custody and collateral management services for a fee, the scholars generally see this as acceptable**

ii. **In case of bank/institution, who is the collateral taker, holding the pledges collateral , in this case the fee to be charged must be actual expense for services**

- The ownership of the collateral and issue of pledge versus title transfer.

  In the conventional market collateral can be given as a pledge or title transfer. In the case of pledge, upon enforcement, the collateral taker could enforce the pledge directly or through the tri-party agent.

- In Europe most of the Repo transactions are documented using the GMRA (UK law) which implies that collateral is transferred using a legal full transfer of ownership but also recognizes that the economic benefit (dividend interest,) of the collateral remains the property of the collateral giver.

Key Considerations

- Title transfer for collateralization have Shariah implications hence pledge over security is recommended from wider Shariah acceptance reason.
- Additional collateral for margin maintenance when required would be similar securities plus cash can also be given for margin maintenance purposes under certain Shariah conditions.
- A Classic REPO, where title is transferred and there is margin maintenance during the life of the repo.
- A Buy Sell Repo, where the title is transferred but there is no margin maintenance.
- Based on the above two scenario, the collateral taker could use the collateral it has received to raise funds to assist in managing any shortfall in liquidity. However, even though, the collateral has moved on, the original collateral taker must return like security back to the original collateral giver upon maturity. If the collateral taker cannot deliver back, then the collateral giver goes to the market to purchase the security and any shortfall is charged to the collateral taker.

Some Tools For Liquidity Management

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Murabahah	Credit Risk>>>>>>>>>>>>>>>>>>>>> Generally Short Term
Salam	Credit Risk>>>>>>>>>>>>>>>>>>>>>> Generally Short Term
Wakalah	Investment Risk / Credit Risk >>>>> Generally Short Term
Qard Hasn	Credit Risk >>>>> Generally Short Term
Sukuk	Credit Risk / Market Risk>>>>>>>> Generally Long Term

Improving Credit Risk Management

- COLLATERALISATION
- Proper Documentation

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- Tenth Harvard University Forum on Islamic Finance
  Harvard Law School - March 24-25, 2012

  Mahmoud Mohieldin, Managing Director, World Bank Group

  Highlighted 6 challenges facing Islamic finance as the industry evolves into its next phase:
  - ✓ Improving regulatory oversight
  - ✓ Strengthening insolvency frameworks
  - ✓ Rebalancing tax treatment

- **Promoting standardization**
- **Ensuring adequate liquidity**
- **Establishing sound risk-management practices**

Apart from Credit Risk Management

A Tool

that

Flows

Liquidity

Into the

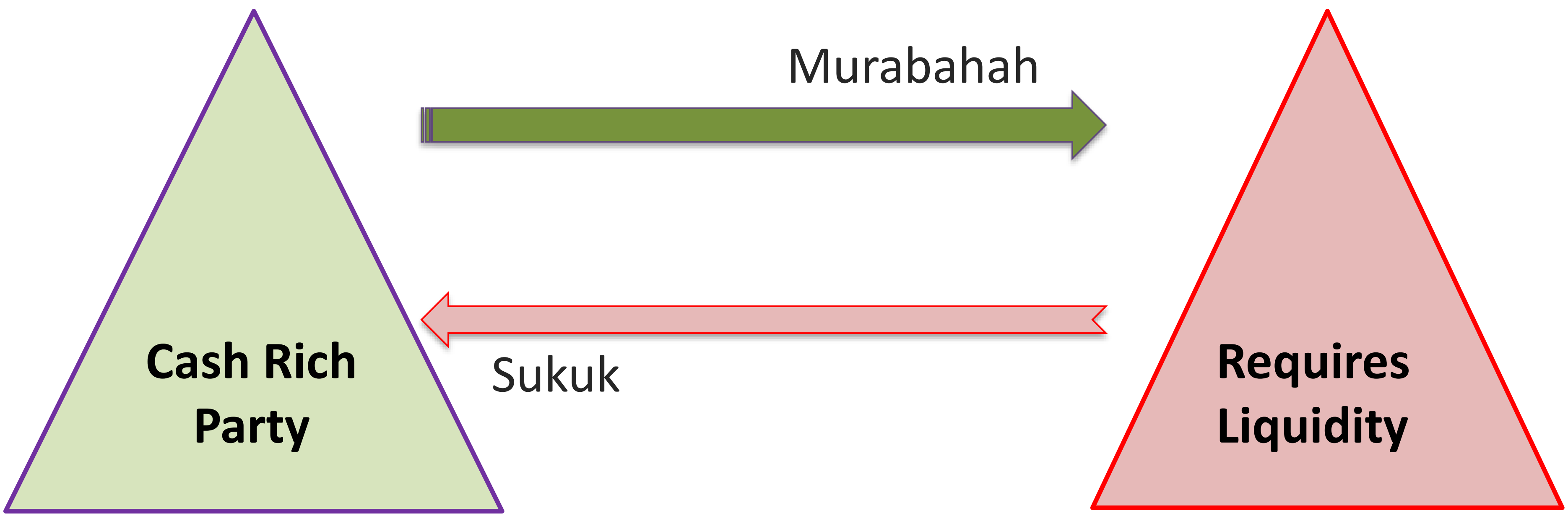
Cash &

Sukuk Market

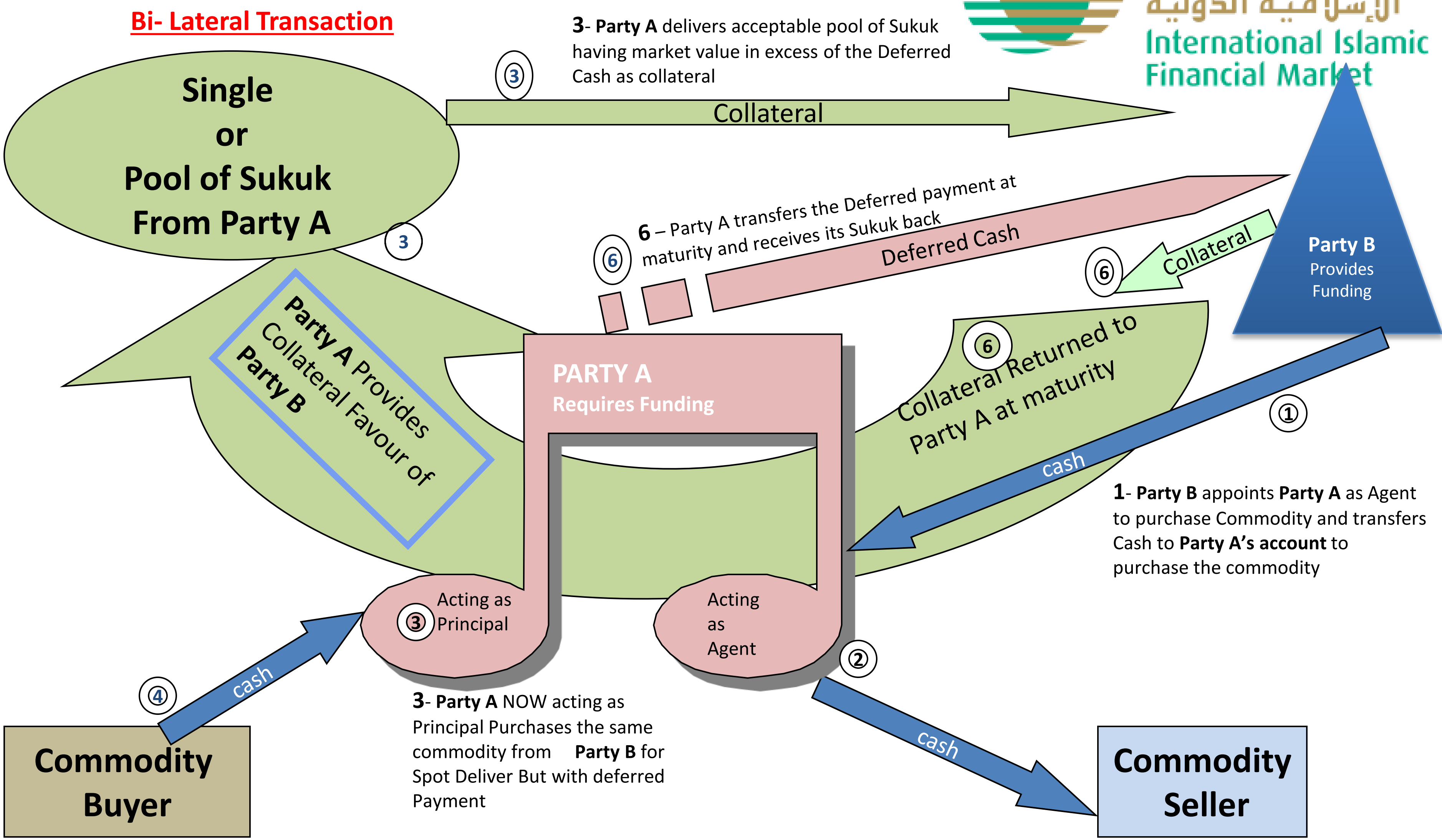
Collateralisation

How does it Work?

Murabahah Collateralised by Sukuk



Collateralization Overall Transaction Flow



3- **Party A** delivers acceptable pool of Sukuk having market value in excess of the Deferred Cash as collateral

1- **Party B** appoints **Party A** as Agent to purchase Commodity and transfers Cash to **Party A's account** to purchase the commodity

3- **Party A** NOW acting as Principal Purchases the same commodity from **Party B** for Spot Deliver But with deferred Payment

4- Party A sells commodity to the market for spot deliver & spot payment and raises Cash for its funding needs

2- Party A buys commodity for Spot Payment and Spot Deliver from the market as Agent for Party B

Benefits of Collateralisation

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Alternative to Clean Lending	Collateralized financing offers a structure that requires some extra operational task but does provide credit enhancement as well as providing an effective liquidity management tool for use with the Collateral Management Agent.
Credit Risk Management	as long as the extra collateral is managed, Counterparty exposure is reduced to the margin threshold plus Sukuk execution risk, rather than a full clean exposure. It can allow for positive capital treatment.
Liquidity Management	Having the comfort of collateral allows the institutions to finance for a longer duration and or larger quantum as the credit risk is reduced.
Central Bank Market Intervention	CB can include Islamic Banks as part of its market liquidity actions (Add or Remove Cash from the system. Also, Islamic Financial Institutions can use this liquidity instrument to raise funds from the CB
Development for Sukuk	Allowing Financial institutions to maintain less cash and allocate more in income generating Sukuk. Giving rise to greater take up of Sukuk by Islamic investors

IIFM Standard MCM Agreement

Objective of the MCM Agreement	Master agreement or framework agreement which sets out the terms upon which the parties can subsequently enter into Collateralized *Murabahah* Transaction that allows a Buyer an opportunity to raise liquidity by creating security of *Shari'ah* compliant assets
Entering into *Murabahah* Transactions	Schedule set out in the MCMA enables individual *Murabahah* transaction to be entered between the Buyer and Seller from time to time and initial Collateral is delivered to the Seller through the grant of security
Margin Maintenance	Margin Maintenance mechanism is outlined whereby the initial collateral is mark to market to maintain an agreed level of exposure. Any Shortfall or excess can be returned subject to an agreed threshold value
Collateral Substitution	Posted Collateral are pledged in a segregated and identifiable account. However, the initial as well as subsequent collateral can be called backed and replaced with any security acceptable to the Seller
***Shari'ah* Approval**	The IIFM MCMA is approved by well respected Scholars represented on IIFM *Shari'ah* Advisory Board

IIFM Master Collateralized *Murabahah* Agreement (MCMA)
&
Guidance Notes

Few Points for Discussion

IIFM MCM Agreement
Operational Guidance Notes

Is it permissible to use Bonds as Collateral	MCMA is a *Shari'ah* Complaint Liquidity Management Agreement and envisaged to use *SUKUK* or other *Shari'ah* compliant securities as collateral. Bonds and Non *Shari'ah* compliant securities are impermissible
Can the Seller make use the Posted Collateral	The collateral are delivered to the seller by granting of security of the assets and they are to be held in a segregated account. The Seller cannot make use of the Posted Collateral. The Collateral may be disposed off in an event of default
What happens to the Profit received from Pledged *Sukuk*	The Pledge *Sukuk* does not involve transfer of ownership. Any profits received in the segregated or identifiable account is for the benefit of the Collateral provider and needs to be returned back to the pledgor
Does the MCMA allow FI to do two way financing	The MCMA is intended to be applied between parties in capacities in which they entered into on execution of the agreement. Separate MCMA has to be executed to allow parties roles to be Reversed
Governing Law	Governing Law is at the option of the Parties. The MCMA has been based on the assumption that the governing law will be English Law. Each Party represents that it has satisfied itself as to *Shari'ah* compliance of Collateralized *Murabahah* Transaction entered under MCMA

Collateralisation

The Key is to Ensure Margin Maintenance

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A (1) *Assuming the Collateral Value Decreases Below the Threshold Variance*

- Bank to provide more (same or other) acceptable *Sukuk*
- Provide other acceptable Collateral as previously agreed
- Or Provide acceptable Letter of Credit
- To bring the collateral level back up to 110%
- If none of the above agreed instrument is delivered then the Party A will be in Default

A (2) *Assuming the Collateral Value <u>Increases</u> Above the Threshold Variance*

- Party B will Return part of the *Sukuk* in order to bring it back down to 110% of the Finance Amount
- Or Party A may consider not to request this extra amount from Party B and may wish to leave extra buffer and save on operational cost

Regulatory, Legal and Other Challenges

- In conventional market repo documentation, the collateral is effected through netting i.e. the ability to close out and set-off in an insolvency where the value of the collateral securities can be determined and applied in set off against the repurchase price. However, the legal framework in most of the OIC countries does not recognize this technique.

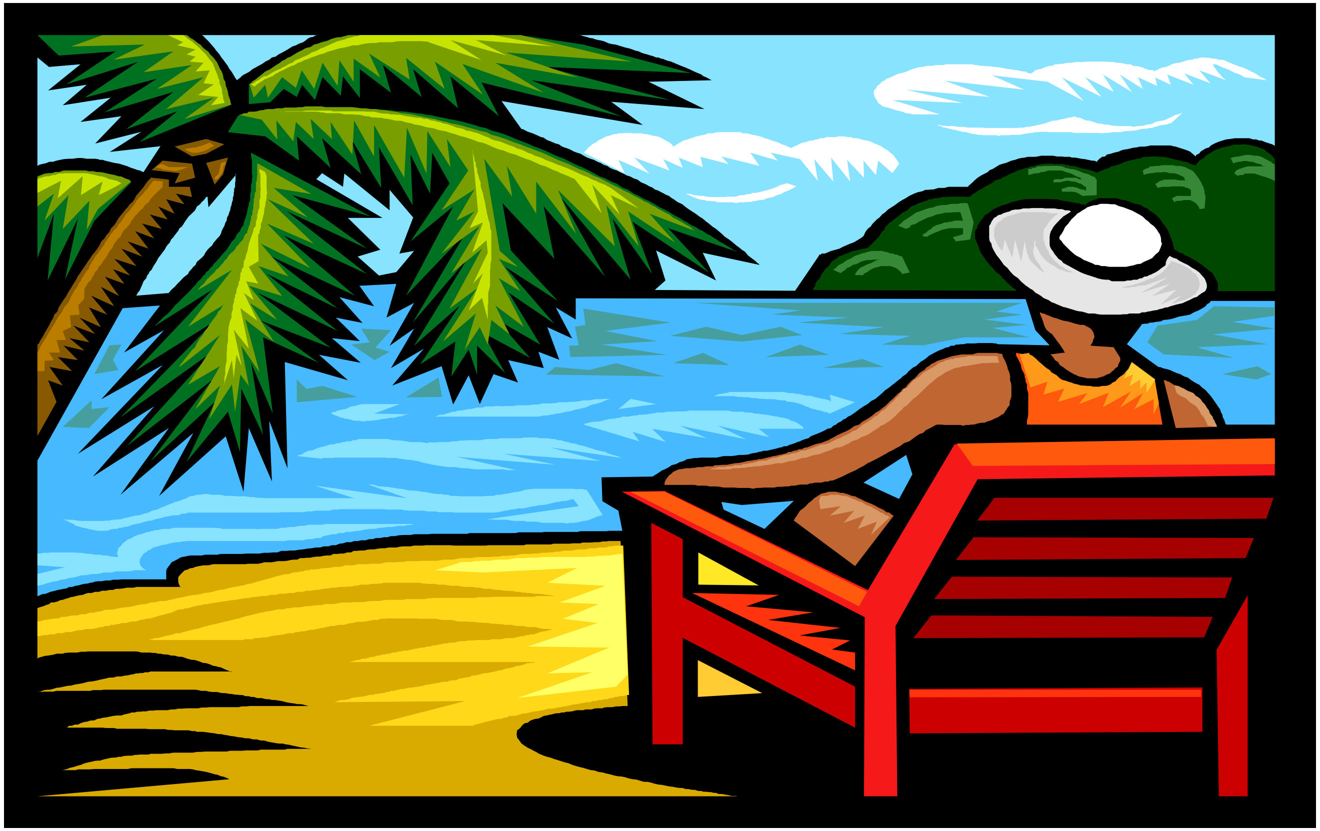
- ✓ The Islamic Industry need to assess and tackle this requirement or find a workable solution

- ❖ **Question:** Certain Institutions either do not carry Sukuk in their portfolio or do not invest in Sukuk. What is the solution for them on Collateralisation?

- ✓ **Answer:** consider Shari'ah compliant Equities.

  These equities can be used as collateral . However there may be issues in terms of Foreign ownership, taxation etc, which needs to be considered before transacting.

Collateralisation



With proper Collateralisation and monitoring in place
One can afford to have a bit of peace

TRI – PARTY

What Does Tri–Party Offer ?

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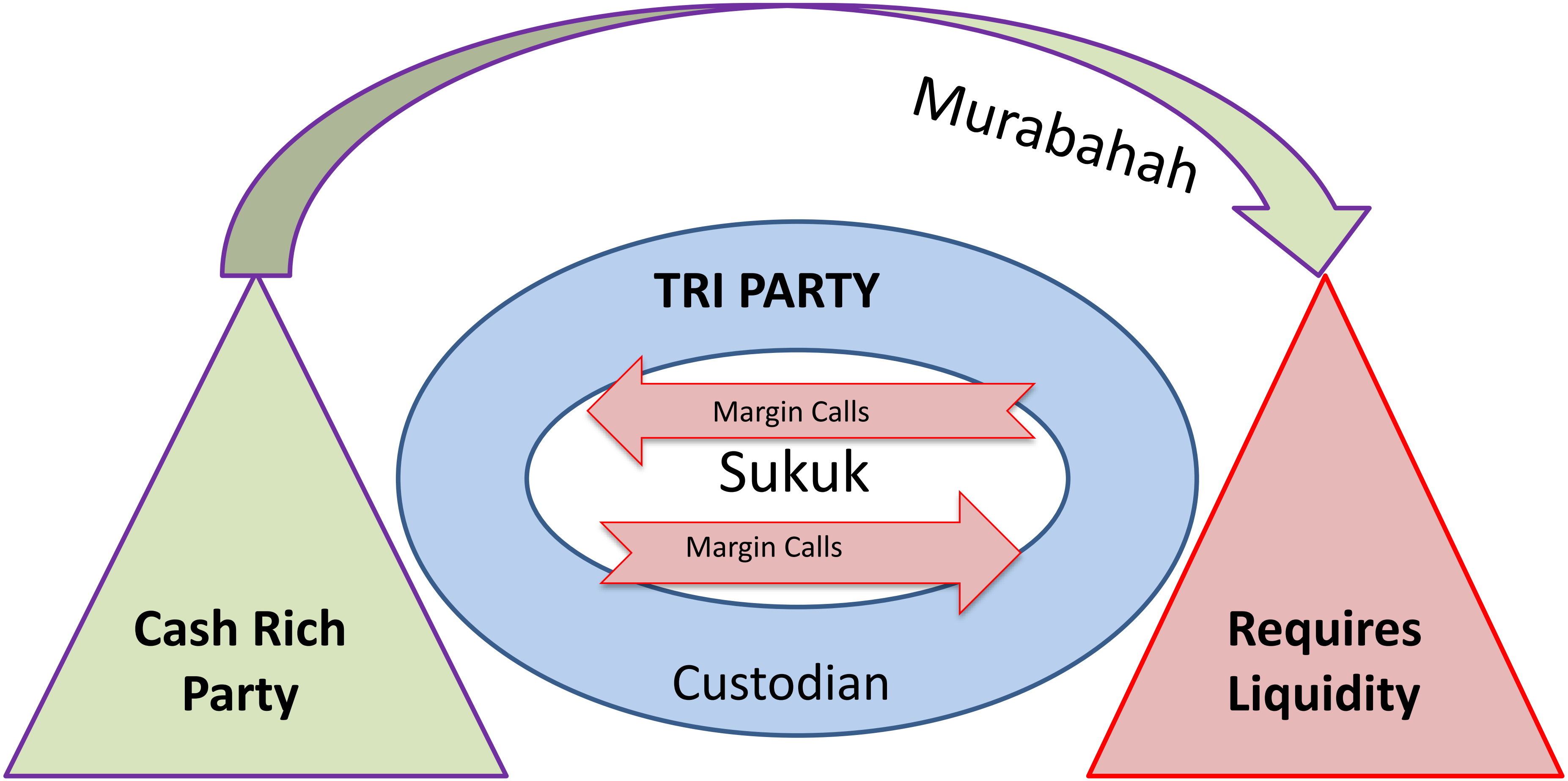
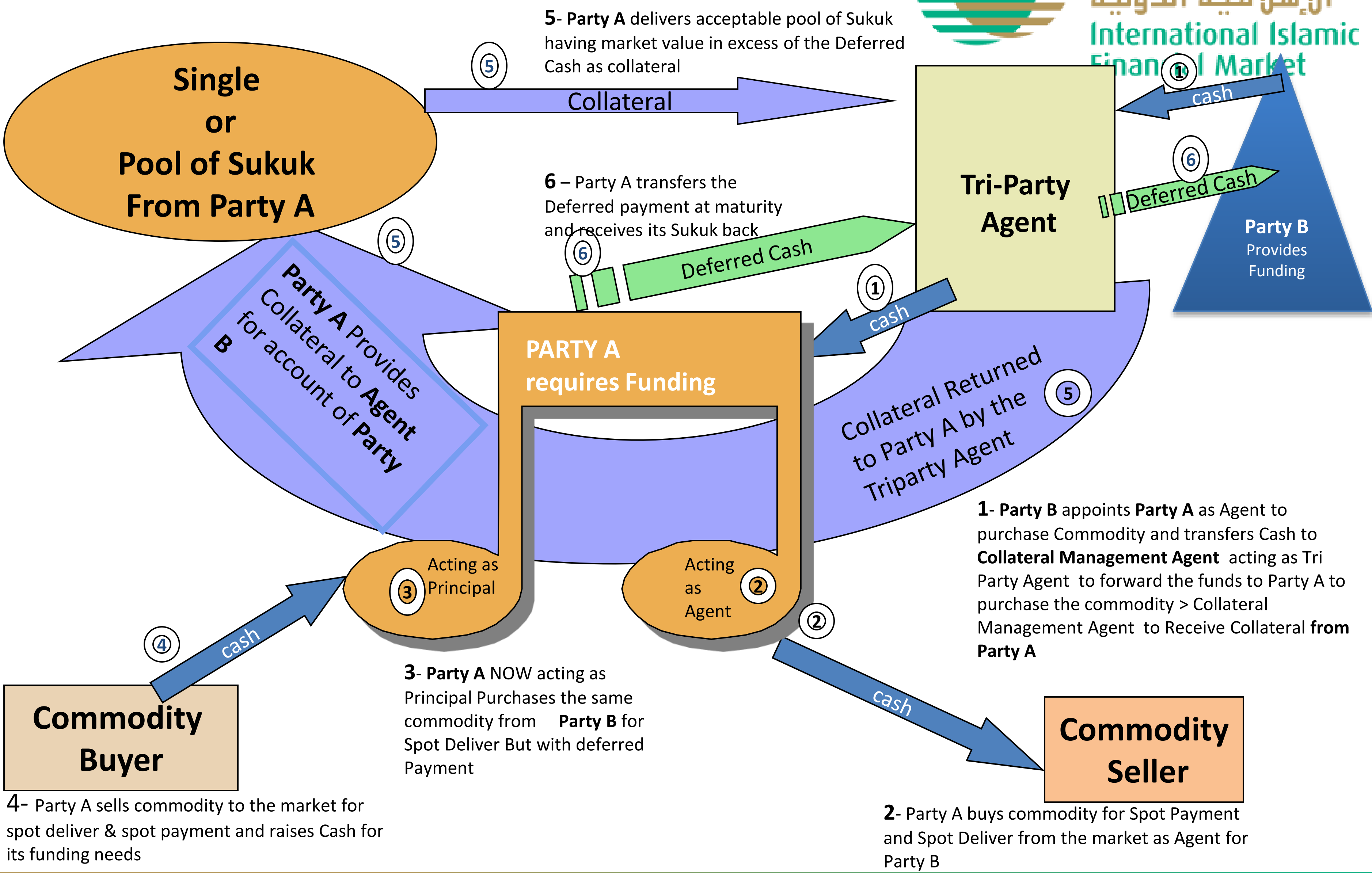
Credit Enhancement	➢ Tri- Party plays and important role by providing independent operational facility while holding underlying collateral
Operation Out Sourcing	❖ Allows entities to participate in Collateralised Financing even when their operation and IT capabilities cannot support due to limitation
Credit Management	➢ Its function is to ensure the Collateral Value are maintained by daily mark to market the Collateral, Call for additional Margin if required, ensure the Collateral is of the type and quality as per the agreement and to process Corporate actions
Expands Client Base	➢ Central Banks, Pension Funds, Asset Managers, Leasing Co and Corporate entities can provide extra cash liquidity to the market. Knowing the exposures are monitored by an independent entity

Murabahah Collateralised by Sukuk



Collateralization Overall Transaction Flow



Tri Party – Collateral Optimisation

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Now

Relax

And

Enjoy

The

Fruits

Knowing your Exposure is Monitored independently by a an engine that optimizes the Collateral pool while ensuring Credit exposure is monitored, reported and actioned

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Thank You

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