SHARED RISK & REWARD

Issue 123 – November 11, 2012

A Note of Caution on Asset-based Sukuk

Humayon Dar wrote a post on his blog recently that raised an important issue about the use of sukuk by companies. After pointing out the similarity between sukuk and conventional bonds in their risk-return profile, he cautioned: "An over-emphasis on asset-based Sukuk structures […] will increase [issuers'] indebtedness, thus magnifying the use of leverage in their capital structures. This will not only endanger operational sustainability of the borrowing corporates but will also contribute to the instability of the Islamic financial system as a whole. "

This is important to understand because much of the language used to describe sukuk focuses on the incorporation of an asset in the transaction makes it more stable, or secure than a conventional bond. However, most sukuk used an asset-based structure where only the legal right to benefit from an asset (the beneficial interest) is transferred, not full legal title.

As a result, the transaction amounts to an unsecured debt, and if the issuer defaults on the sukuk, the investors have only the right to line up with other unsecured creditors to seek recovery from the issuer. They do not have the ability to take the asset and sell it to recover their investment.

For the issuer, the disconnect between the performance of the underlying asset and the coupon and principal payments due to investors means it does not allow for losses to be shifted to sukuk holders (except in a liquidation, when the equity of the company is likely to be lost as well). There are slight differences in mudaraba sukuk (post-AAOIFI) where some of the principal may be decreased if the underlying assets do not generate enough income to pay the coupons.

As a result, the impact for the financial system of companies taking upon excessive debt by issuing sukuk will be identical to the situation where companies borrow too much with conventional debt. If too many companies become too leveraged (particularly in the financial sector), it sets up a possible debt-fuelled financial crisis.

Asset-backed sukuk may not be feasible in for many issuers, but the one protection they do provide is that investors can claim an asset (with caveats about whether they will be able to enforce on the asset in a default) while companies that issue asset-backed sukuk will potentially lose the assets backing the sukuk, but will not necessarily fail themselves if the asset fails to generate sufficient income to pay coupon and principal.

Until next week,
Blake Goud

Reading List

Humayon Dar: A Note of Caution on Sukuk (link)

The "Immunity Myth, Debunked by the IFSB (Sharing Risk)

Should Islamic finance move towardasset-backed securitization? (Sharing Risk)

Blog Posts This Week

Bahrain changing its deposit insurance fund

Malaysia to host a mega Islamic bank (or several?)

Equity-based sukuk (IFSB proposed rules on capital adequacy)

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