A CRITICAL LOOK AT THE BASEL III COMPLIANT SUKUK ISSUANCES

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ABSTRACT

Against the backdrop of the global financial crisis, the Basel Committee on Banking Supervision promulgated a new regulatory framework for financial institutions, known as Basel III. Given the uniqueness of Islamic banks' products and operations, the implementation of Basel III rules has created several challenges to Islamic financial institutions (IFIs) especially with regards to capital adequacy and liquidity requirements. To satisfy the Basel III capital requirements, a new segment of sukuk, so called 'Basel III compliant sukuk', has been innovated. Basel III compliant sukuk are seen as instruments that can address the capital adequacy needs of Islamic banks. The momentum is expected to pick up pace as Basel III accords are phased-in through the coming years. This paper aims to explore this trend and to raise some concerns about it. After giving the features of some of the selected issuances, five concerns regarding these sukuk have been identified. These are about loss absorption mechanism, cost of financing, cases of tax or capital event, shari'ah governance and limited secondary market trading. Addressing these concerns would be beneficial for potential issuers and the market itself. Otherwise, these concerns may hamper the growth of this new segment of Islamic capital markets and affects the reputation of these instruments.

Key Words: Sukuk, Basel III, Shari'ah Governance.

1. INTRODUCTION

Recent growth of Islamic finance based on the principles of risk-sharing and participatory finance offers potential alternatives to global financial markets. Total size of financial assets under this growing industry reached nearly $2.0 trillion in 2014[1]. Although the banking sector dominates the market (about 80%), asset-based capital markets instruments are a growing source of financing for both Muslim and non-Muslim countries at both domestic and international markets.

Sukuk is representing a right of ownership for the holders on the underlying assets and the income generated from them. Although it is a relatively new innovation in Islamic finance, it has experienced significant growth. Sukuk has a similar return and risk structure as compared to conventional debt instruments but they are not debt instruments in the monetary sense. They may be issued in asset-backed or asset-based structure that both of these types link securities to underlying assets. The market has experienced approximately 26% cumulative average annual growth rate in the last couple of years and have reached an annual issuance of $119 billion in 2014[2]. According to Standard and Poor's total issuance of sukuk is expected to be exceed $100 billion level again in this year[3].

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[1] MIFC (2015). "Islamic Finance: Prospects and Challenges"

[2] MIFC (2015). "*Global Sukuk Report: Q1 2015*"

[3] S&P Ratings Direct (2015). "*For Sukuk Issuance, Emerging Headwinds May Cause Turbulence In 2015"*

Against the backdrop of the global financial crisis, the Basel Committee on Banking Supervision promulgated a new regulatory framework for financial institutions, known as Basel III. Given the uniqueness of Islamic banks' products and operations, the implementation of Basel III rules has created several challenges to Islamic financial institutions (IFIs) especially with regards to capital adequacy and liquidity requirements.

To satisfy the Basel III requirements, a new segment of sukuk, so called 'Basel III compliant sukuk', has been innovated. Basel III compliant sukuk are seen as instruments that can address the capital adequacy needs of Islamic banks. Proceeds of these issuances are classified as either Tier 1 or Tier 2 capital with respect to their features. All Tier 1 sukuk examined in this paper were issued in Mudaraba format up to now. Mudaraba structure is one of the main pillar in Islamic finance with its equity-like format in compliance with risk sharing. Recently, sukuk have been criticized for ignoring the risk sharing and mimicking the conventional bonds. Thus, mudaraba type issuances are also important to address such kind of criticisms. On the other hand, Tier 2 sukuk examined in this paper were issued in different hybrid formats such as mudaraba-ijara and mudaraba-murabaha. Sukuk issued by Asya Sukuk Company Limited is explored in this paper as an example of Tier 2 sukuk.

Basel III compliant sukuk would support the growth of Islamic capital markets. However, there are still some important concerns about this trend and issuances. This paper aims to explore this trend and to raise some concerns about it. After giving the features of some of the selected issuances, concerns regarding four main critical issue have identified. These are about loss absorption mechanism, cost of financing, cases of tax or capital event, shariah governance and limited secondary market trading. Addressing these concerns would be beneficial for potential issuers and the market itself.

The rest of the paper is organized as follows. In Section II, we briefly review the Basel III capital requirements and IFIs challenge to implement these rules, while in Section III, we describe Basel III compliant sukuk issue trend by stating the motivation behind these issuances, terms and conditions, and structures outstanding Tier 1 and selected Tier 2 sukuk in the market. In Section IV, we present concerns about issuances that have to be addressed. Section V provides some concluding remarks.

2. BASEL III CAPITAL ADEQUACY STANDARDS

The implementation of the Basel III, which modified the existing regulatory framework of Basel II, have begun from 1 January 2013. Against the backdrop of the global financial crisis, Basel III primarily requires all banks, including Islamic banks, to strengthen their capital and liquidity positions by holding higher quality capital. The goal is to enable banks to absorb financial shocks. It also requires to maintain higher level of liquidity aiming to reduce banks dependency on money market instruments. In other words, the new accord is trying to improve the banking sector's ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spillover from the financial sector to the real economy.

According to Basel III requirements, banking institutions have to meet the following minimum capital requirements expressed in risk-weighted assets: 3.5% common equity tier-1 capital (CET1), 4.5% tier-1 capital and 8% total capital. During the transitional period from 2013 up to and including 2019, these ratios will gradually be stepped up to 4.5% CET1, 6% tier-1 capital and 8% total capital. In addition, a conservation buffer is required to be built up to a percentage of 2.5% starting from 1st January 2016 and through to 1st January 2019. Ultimately, banks are required to hold 10.5% of their total capital expressed in risk-weighted assets. Table-1 shows the Basel III timeline.

Table 1- Basel III Timeline

	2013	2014	2015	2016	2017	2018	2019
Common Equity	Initial Compliance					Full Compliance	
Conservation Buffer				Initial Compliance			Full Compliance
Liquidity Coverage Ratio			Full Compliance				
Net Stable Funding Ratio						Full Compliance	
Leverage Ratio	Regulatory Reporting		Public Reporting			Full Compliance	
Countercyclical Capital Buffer				Anticipated Application			

Source: www.bis.org

In addition, Basel III also redefines the meaning of capital. According to Basel III, the components of Tier 1 capital consist of common equity as core capital, and preferred stock and hybrid securities as additional capital. Subordinated bonds and loans are counted as Tier 2 capital.

To be classified as Tier 1 capital, the criteria for non-common equity instruments (Additional Tier 1 ("AT1") capital) includes:

- subordinated on liquidation to all depositors and all creditors (including subordinated creditors)
- not secured or guaranteed
- perpetual, with no incentives to redeem and no investor put option
- fully discretionary (cancellable) non-cumulative dividends/coupons
- callable by bank only after 5 years, but no expectation of redemption to be created any return of capital only with prior supervisory authorization
- capable of loss absorption on a going concern basis i.e. principal write down or conversion into common equity at pre-specified trigger point
- no feature which hinders recapitalization

Although there seems a resemblance between preferred stocks and AT1 capital, they have some differences. Cumulative preferred stock contradicts one of the requirement of AT1 capital which states that the issuer retain discretion over payments of dividends and full access to cancelled payments. Most trust preferred securities will also be excluded from AT1 capital based on certain of their more common features, such as cumulative dividends and the existence of a maturity date. Preference shares may qualify as AT1 Capital depending on how they are structured.

Since AT1 capital is included in Tier 1 capital ratio, it has utmost importance for financial institutions. AT1 capital is attractive for a number of reasons:

- The discretion to cancel distributions, together with the requirement of principal write-down or mandatory conversion to common equity increase the resilience of a financial institution during challenging financial conditions.
- AT1 instruments also present a cost effective means of accessing a wider investor base, including investors in Asia, the Middle East and Europe, without diluting shareholders.

- This helps preserve ownership structures in jurisdictions, such as the UAE, where governments, government-related entities and members of ruling families often hold, and wish to retain, substantial stakes in these financial institutions.
- The instruments are attractive to investors since they allow investors to diversify their risk portfolio and invest in companies with solid fundamentals at higher yields than they would receive from conventional debt instruments.

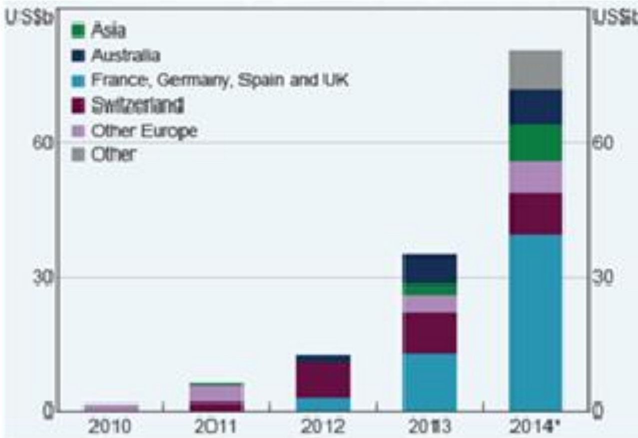
It is claimed that with the new Basel III capital criteria there is a convergence between AT1 and Tier II capital. The main difference between these two types of capital is stated in Basel III accords as following: Additional Tier I instruments are "going-concern" capital (i.e. capital that can be depleted without placing the bank into insolvency, administration or liquidation) and Tier II instruments are "gone-concern" capital (i.e. capital that is subordinated to depositors in the winding-up or insolvency of the bank). Table 2 shows the other features of both types.

Table 2: Features of AT1 and Tier II types of capital instruments

Features	AT1 Instruments	Tier II Instruments
Ranking	Subordinated	Subordinated
Maturity	Perpetual, no maturity date	Original maturity of at least 5 years
Call Option	Callable at minimum of 5 years	Callable at minimum of 5 years
Discretionary periodic distributions	At the full discretion of the bank	None
Principal loss absorption linked to a non-viability	Write-off/conversion upon a non-viability event	Write-off/conversion upon a non-viability event
Other principal loss absorption terms	Write-off/conversion when the CET1 capital ratio ≤ 5.125%	None

Source: “A Credit Rating Agency’s Perspective on Basel III sukuk", IIFM Industry Seminar on Islamic Financial Market, RAM Ratings, 1 December 2014.

Conventional banks have been issuing AT1 capital instruments and issuances have increased strongly in recent years. The main reason for banks to issue is to raise their capital in order to meet the stricter Basel III capital requirements and to replace maturing instruments issued under the Basel II framework. As shown in Figure 1, the issuance amount reached nearly 80 billion USD as of September, 2014. Moreover, the low interest rate environment has supported investor demand. As a reflection of their high risk profile, these securities offer higher yields than senior debt or term deposits. Thus, there is strong demand for these securities from yield seeking investors. As shown in Figure 2, investors with benchmark driven investment strategies such as asset managers, hedge funds and banks are investing in these securities mostly. Higher yield offered by these securities makes them attractive for these type of investors.



Share of issuance, per cent

Investor Type	2013	2014
Asset managers	63	59
Hedge funds	12	21
Insurance/pension funds	6	9
Banks/private banks	16	10
Other	3	1

(a) From a sample of 11 AT1 European contingent convertible instruments with data available on investor distribution

Figure 1: Global Banks' AT1+T2 Securities Issuance and Investor Types
Source: Financial Stability Review, September 2014, Reserve Bank of Australia.

3. BASEL III COMPLIANT SUKUK

Since IFIs and Islamic products have their own characteristics, the implementation of Basel III rules requires more clarification. In December 2013, the Islamic Financial Services Board (IFSB) released IFSB-15 for the purpose of addressing this issue.

The IFSB-15 introduces a framework for capital adequacy and liquidity requirements and it is an amended and improved version of two previous IFSB standards on capital adequacy, namely IFSB-2 and IFSB-7. IFSB-2 focused on capital adequacy standards for IFIs while IFSB-7 focused on capital adequacy requirements for sukuk, securitizations and real estate investments. Like Basel III, IFSB-15 defines common equity as the Tier 1 core capital and preferred stock as the additional Tier 1 capital. However, it is important to note that preferred stock is only considered a Shari'ah-compliant instrument in some jurisdictions such as Malaysia.

In addition, perpetual musharakah sukuk is also counted as AT1 capital, while mudaraba and wakalah sukuk with maturity of five years or more are counted by IFSB-15 as components of IFIs' Tier 2 capital. However, in practice, other types of sukuk may also be classified as either AT1 or the component of Tier 2 capital as long as the sukuk fulfill IFSB-15 requirements for each category of capital. In summary, the IFSB-15 has stressed the important role of sukuk in the Basel III era.

It is obvious that an opportunity emerges for IFIs to boost their Tier 1 capital by issuing sukuk which comply with Basel III and IFSB-15 regulatory requirements. Advantages and motivations behind issuing this new breed of sukuk are stated as follows:

- They can be an alternative funding source for institutions that face difficulties in raising capital through equity issuances as global financial instability depresses stock markets.
- Such an innovation offers the potential for sukuk underwriters to expand market shares and further boost the supply of sukuk in global markets.
- They are eligible instruments for both conventional and Islamic institutions on the condition that funds are utilized for Shariah-compliant activities. Hence, market expectations are that issuances will steer interest among other banks, particularly in the Middle East where regulators generally require higher levels of capital, to explore issuances of such sukuk.
- They have attractive features for issuers such as being equity-like and non-dilutive, having no redemption and discretionary periodic payments, etc.

Shariah-compliant financial engineering and innovative product development enabled the issuance of the world's first Basel III compliant sukuk in November 2012 which was classified as

Basel III compliant AT1 capital instrument. The world's first T2 capital instrument was issued in March 2013.

As the Basel III standards come into effect gradually, a total of 7 Basel III compliant AT1 capital adequacy sukuk have been issued as of end of 2015, raising nearly USD 5 billion in proceeds for 5 different issuing banks. On the other hand, there are more than 12 Basel III compliant T2 capital adequacy sukuk in the market. In Table 3, we only put the information of 12 T2 sukuk outstanding. Among them, Malaysian Islamic banks have collectively issued six Basel III compliant T2 sukuk to date, followed by Saudi Arabia's five, and Turkey's one Basel III compliant T2 sukuk. In terms of issuance volume, including both AT1 and T2, Saudi Arabia accounts for 52% of the total Basel III sukuk issued; UAE 38% and Malaysian Islamic banks, one bank from Qatar and one bank from Turkey account for the remaining 10%.

Table 3: Basel III Compliant Sukuk (all AT1 and some of T2, as of end of 2015)

Sukuk	Structure	Country	Issue date	Tenure	Size	Rating (Moody's/ Fitch)	Type of capital
ADIB Capital Invest 1 Ltd	Mudaraba	United Arab Emirates	19th Nov 12	Perpetual (Callable 5-Yrs)	USD1bln	A2/A+	AT1
DIB Tier 1 Sukuk Ltd	Mudaraba	United Arab Emirates	20th Mar 13	Perpetual (Callable 6-Yrs)	USD1bln	Baa1/A	AT1
Al Hilal Bank	Mudaraba	United Arab Emirates	30th June 14	Perpetual (Callable 5-Yrs)	USD500mln	A1/A+	AT1
DIB Tier 1 Sukuk Ltd	Mudaraba	United Arab Emirates	15th Jan 15	Perpetual (Callable 5-Yrs)	USD1bln	Baa1/A	AT1
NCB Tier 1 Sukuk	Mudaraba	Saudi Arabia	22th Jun 15	Perpetual (Callable)	SAR1bln	Aa3/A+	AT1
NCB Tier 1 Sukuk	Mudaraba	Saudi Arabia	15th Jul 15	Perpetual (Callable)	SAR2bln	Aa3/A+	AT1
QIB Tier 1	Mudaraba	Qatar	30th Jun 15	Perpetual (Callable 6 Yrs)	QAR2bln	-/A+	AT1
Asya Sukuk Comp. Ltd	Ijara-Murabaha	Turkey	28th Mar 13	10 Yrs	USD250mln	Ba3/-	T2
SHB Tier 2 Sukuk	Combination	Saudi Arabia	15th Dec 13	10 Yrs (Callable 5-Yrs)	SAR2.5bln	-/-	T2
SABB Tier 2 Sukuk	Mudaraba-Murabaha	Saudi Arabia	17th Dec 13	7 Yrs (Callable 5-Yrs)	SAR1.5bln	A/-	T2
NCB Tier 2 Sukuk	Mudaraba	Saudi Arabia	20th Feb 14	10 Yrs (Callable 5-Yrs)	SAR5bln	-/-	T2
Am Islamic	Murabaha	Malaysia	28th Feb 14	10 Yrs (Callable 5-Yrs)	MYR200mln	AA3*	T2
Am Islamic	Murabaha	Malaysia	25th Mar 14	10 Yrs (Callable 5-Yrs)	MYR150mln	-/-	T2
Maybank Islamic	Murabaha	Malaysia	7th Apr 14	10 Yrs (Callable 5-Yrs)	MYR1.5bln	-/-	T2
RHB Islamic	Murabaha	Malaysia	15th May 14	10 Yrs (Callable 5-Yrs)	MYR500mln	AA3*	T2
Saudi Inv. Bank	Hybrid	Saudi Arabia	5th June 14	10 Yrs (Callable 5-Yrs)	SAR2bln	-/-	T2
Public Islamic	Murabaha	Malaysia	9th June 14	10 Yrs (Callable 5-Yrs)	MYR500mln	AA1*	T2
Hong Leong Islamic	Ijara	Malaysia	17th June 14	10 Yrs (Callable 5-Yrs)	MYR400mln	AA2*	T2
Banque Saudi Fransi	Hybrid	Saudi Arabia	18th June 14	10 Yrs (Callable 5-Yrs)	SAR2bln	Aa3/A/A	T2

** RAM Ratings Source: Zawya, KFHR and MIFC*

When we look at the structure of issuances, all AT1 types were issued in mudaraba format. In terms of T2 types, Malaysian based issuers preferred murabaha (except Hong Leong Islamic) and Saudi Arabian based issuers used hybrid models. Since this paper is intended to shed light on both type of sukuk issuances, we will be elaborate the structures and features of these issuances in the next part of this section.

AT1 and T2 Sukuk Structures

The first AT1 issuance made by Abu Dhabi Islamic Bank (ADIB) in 2012. Then three issuance from UAE based banks followed it. Since all these four issuances until 2015 made by UAE based banks, it would be better to understand the current situation of the implementation of Basel III in there. Whilst the implementation of Basel III is still in its preliminary phases, the central bank of the UAE begun rulemaking in response to Basel III requirements with its first guidance circular released in July 2012. The UAE is not alone and the authorities in each of the current member states of the GCC have also started to prepare for implementation of Basel III or have signaled an intention to do so. In anticipation of the implementation of Basel III, both regional and international banks have therefore started to increase their Tier 1 capital ratios. As a proof, Saudi Arabia based National Commercial Bank (NCB) and Qatar based Qatar Islamic Bank (QIB) issued their first sukuk in 2015. On the other hand, the first T2 sukuk issued by Bank Asya from Turkey. After that, there were so many issuances in these type of sukuk. Since they were mostly issued in local markets, it is hard to compile all T2 issuances.

In table 4, details of four AT1 issuances and one T2 issuance are presented. All AT1 sukuk have mudaraba structure in the market. UAE based issuances are chosen as an example and case studies because the details of them are open to the public. T2 sukuk have different formats. As a case, the first issuance made by Bank Asya from Turkey is chosen.

Table 4: Details of Some Basel III Compliant Sukuk Issuances

SUKUK NAME	ADIB TIER 1	DIB TIER 1	AHB TIER 1	DIB TIER 1	ASYA TIER 2
Issue Amount	1,000,000,000 USD	1,000,000,000 USD	500,000,000 USD	1,000,000,000 USD	250,000,000 USD
Issue Date	19 November 2012	20 March 2013	30 June 2014	20 January 2015	28 March 2013
Maturity Date	Perpetual	Perpetual	Perpetual	Perpetual	28 March 2023
Issue Price	100	100	100	100	100
Profit Rate	6.375%	6.250%	5.500%	6.750%	7.500%-6.525%
Benchmark Rate	6Yr MS-96 bps	6 Yr Ms-129 bps	5Yr MS-177 bps	-	-
Status	Subordinated	Subordinated	Subordinated	Subordinated	Subordinated
Structure	Mudaraba	Mudaraba	Mudaraba	Mudaraba	Ijara-Murabaha
Regulation	Reg S	Reg S	Reg S	Reg S	Reg S
Listing	London SE	Irish SE	Irish SE	Irish SE	Irish SE
Over-subscription	15.5x	14x	9.5x	2.5x	
Allocation Breakdown	38% Asia, 32% Middle East, 26% Europe, 4%	38% Middle East, 29% Asia, 29% Europe, 4% US	40% Middle East, 31% Asia, 29% Europe	N/A	52% Europe, 35% Middle East, 13% Asia

	US Offshore Investors	Offshore Investors			
Embeded Options	Callable after 6 years	Callable after 5 years	Callable after 5 years	Callable after 6 years	Callable after 5 years
Dividend Stopper/Pusher	Stopper No Pusher	Stopper No Pusher	Stopper No Pusher	Stopper No Pusher	N/A
Going Concern Loss Absorption Trigger	No principal loss absorption	No principal loss absorption	No principal loss absorption	No principal loss absorption	No principal loss absorption
Non-viability Loss Absorption	Risk factor on potential statutory regime	Risk factor on potential statutory regime	Covered through permitted amendment via full and permanent write-down	Covered through permitted amendment via full and permanent write-down	Risk factor on potential statutory regime.
Coupon Discretion	• Non-cumulative discretionary distributions • Non-payment upon (i) Bank having insufficient Distributable Profits, (ii) breach by Bank of Applicable Regulatory Capital Requirements, (iii) the request of the regulator, (iv) Solvency Condition not being met or (v) Bank electing not to pay • Non-cumulative discretionary distributions • Non-payment upon (i) Bank having insufficient Distributable Profits, (ii) breach by Bank of Applicable Regulatory Capital Requirements, (iii) the request of the regulator, (iv) Solvency Condition not being met or (v) Bank electing not to pay • Non-cumulative discretionary distributions • Non-payment upon (i) Bank having insufficient Distributable Profits, (ii) breach by Bank of Applicable Regulatory Capital Requirements, (iii) the request of the regulator, (iv) Solvency Condition not being met or (v) Bank electing not to pay				None

Source: Prospectuses, prepared by author.

All AT1-type sukuk are based on the mudaraba contract which allows all the flexibility of non-payment, non-accrual as well as write-down of the capital under certain circumstances without triggering any breach or non-payment event. Sukuk Mudaraba, which is generally seen under Shariah law as a profit-and-loss sharing partnership, provides an ideal Islamic structure to accommodate the features of AT1 capital, such as the discretionary profit payments.

Sukuk Mudaraba is based on Mudaraba contract. The AAOIFI defines mudaraba as a contract based on trust whereby one party provides capital (rab-al mal) and the other party provides management of such capital (mudharib). The permissibility of mudaraba in Sharia law is indisputable. There are strong evidence from Quran, Sunnah and consensus of scholars (ijma)[4].

[4] For further references: “Sukuk”, Securities Commission Malaysia, 2009.

According to the AAOIFI[5]:

"*The evidence of permissibility of issuing sukuk mudharabah rests on the reality that theses sukuk have been derived from one of the traditional and permissible agreements. This resulted in clear Shari'ah permissibility of issuing sukuk mudharabah.*"

The Council of the Islamic Fiqh Academy defines mudaraba sukuk as[6]:

"Investment instruments which allocate the muqaradhah capital (mudharabah) by floating certificates, as an evidence of capital ownership, on the basis of the shares of equal value, registered in the name of their owners, as joint owners of shares in the venture capital or whatever shape it may take, in the proportion to the each one's share therein."

Sukuk are structured to give investors an ownership interest in the underlying assets, investors have in the past sought to access these assets in times of financial stress. Under mudaraba structure this is not possible and investors have to be informed well about it. With regulatory capital issuances such as AT1 sukuk investors potentially may not be able to exercise rights to redeem because they are holding paper which could be perpetual.

Case for T2 sukuk is issued in hybrid format. It includes both ijara and murabaha contracts. Ijara sukuk is defined in AAOIFI as follows[7]:

"Certificates of ownership in leased assets

These are certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets.

Certificates of ownership of usufructs

Certificates of equal value issued by the owner of an existing asset either on his own or through a financial intermediary, with the aim of leasing the asset and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the certificates.

Certificates of equal value issued by the owner of the usufruct of an existing asset (lessee), either on his own or through a financial intermediary, with the aim of subleasing the usufruct and receiving the rental from the revenue of the subscription so that the holders of the certificates become owners of the usufruct of the asset."

Murabaha sukuk is defined in AAOIFI as follows[8]:

[5] Standard 17, AAOIFI Investment Sukuk Standard.
[6] Resolution No.30
[7] Standard 17, AAOIFI Investment Sukuk Standard.
[8] Standard 17, AAOIFI Investment Sukuk Standard.

"These are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that the certificate holders become the owners of the Murabaha commodity."

Next section will be about the structures of AT1 and T2 sukuk cases. It will elaborate the mechanism behind the fund raising process and facilitate to understand Shariah securitization process.

Structures of AT1 and T2 Sukuk Cases

The four AT1 sukuk issuances used mudharabah structure as shown in the diagram below:

Diagram 1: AT1 Mudharabah Structure

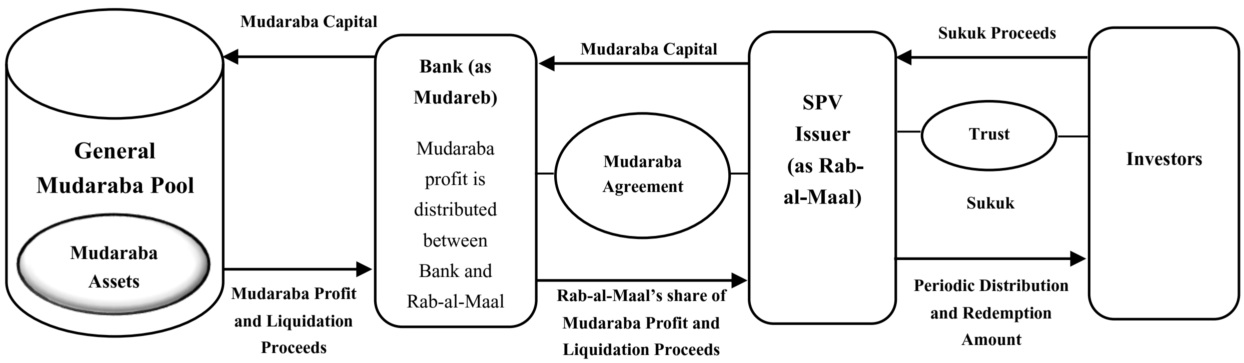


Diagram Explanation

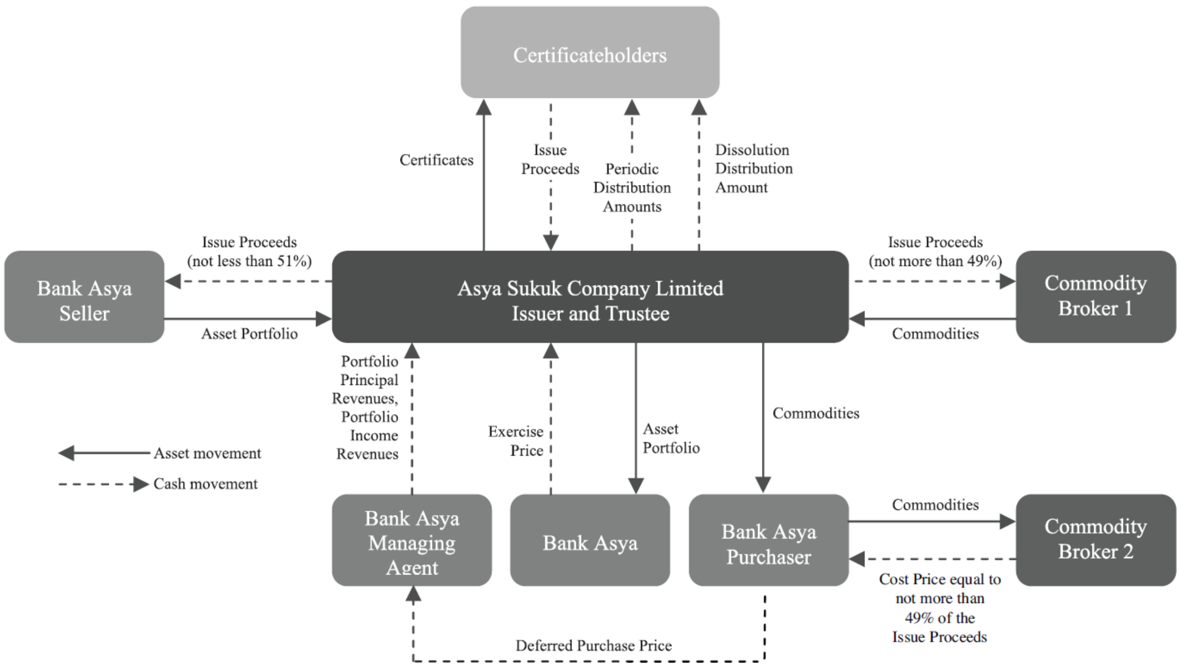
1. The Issuer issues Sukuk (which shall be perpetual and accordingly shall not have a fixed redemption) to the investors and collect the proceeds therefrom.
2. Pursuant to a Mudaraba Agreement between Bank (as Mudareb) and the Issuer (as Raab-al-Maal), a Mudaraba is constituted and the proceeds from issuance are contributed by the Issuer as the initial Mudaraba Capital.
3. Bank (as Mudareb) will invest the Mudaraba Capital in the general business of Bank in accordance with an agreed Investment Plan. The Mudaraba Capital as so invested will be converted into undivided assets in the General Pool as the Mudaraba Assets. Bank shall be entitled to co-mingle its own assets with the Mudaraba Assets.
4. Pursuant to the terms of the Mudaraba Agreement, Bank will pay (after deducting its share of the profit in respect of its co-mingled assets and in accordance with an agreed profit sharing ratio) Mudaraba Profit to the Issuer and the Issuer will utilize Mudaraba Profit to pay the Periodic Distribution Amounts to investors.
5. Payments of the Raab-al-Maal Mudaraba Profit by Bank (as Mudareb) are at the sole discretion of Bank (as Mudareb) and may only be made in circumstances where Bank will not be in breach of certain solvency and minimum capital conditions, before or as a result of making such payment.
6. Subject to certain conditions, at the discretion of Bank (as Mudareb), Bank (as Mudareb) may liquidate (on the basis of a constructive liquidation) the Mudaraba in whole, either: **i)** on the First Call Date or any Mudaraba Profit Distribution Date after the First Call Date; or **ii)** On any

date on or after the date of the Mudaraba Agreement upon the occurrence of **(i)** a Tax Event[9] or **(ii)** Capital Event[10].

7. The Mudaraba shall be automatically liquidated upon a winding-up, bankruptcy, dissolution or liquidation or other analogous event) of the Mudareb and/or if a Dissolution Event occurs.

Bank Asya T2 sukuk issuance had a hybrid structure which consists of Ijara and Murabaha methods as shown in the diagram below:

Diagram 2: T2 Hybrid Structure



Source: Prospectus

Diagram Explanation

1. The Issuer issues Sukuk to the investors and collect the proceeds.
2. Issuer will pay not less than 51% of the Issue Proceeds (the Tangible Asset Percentage) to Bank Asya as the purchase price for the purchase of an initial portfolio (the Asset Portfolio) of (i) certain non-real estate assets (including related ijara contracts and all rights under such contracts) and (ii) sukuk certificates.
3. Issuer will pay not more than 49% of the Issue Proceeds (the Commodity Murabaha Percentage) to a commodity broker to purchase Sharia compliant commodities (which can be

[9] **Tax Event:** Bank or the Trustee (as the case may be) would, as a result of a Tax Law Change, in making any payments under the Mudaraba Agreement (in the case of Bank) on the next due date for a payment of Mudaraba Profit or the Certificates (in the case of the Trustee) on the next due date for payment of a Periodic Distribution Amount (as the case may be) (whether or not a Non-Payment Event has occurred), be required to pay Additional Amounts (and such requirement cannot be avoided by Bank or the Trustee (as the case may be) taking reasonable measures available to it).

[10] **Capital Event:** It is deemed to have occurred if Bank is notified in writing by the Financial Regulator to the effect that the face amount (or the amount that qualifies as regulatory capital, if some amount of the Certificates are held by Bank or whose purchase is funded by Bank) of the Certificates is excluded (in full or in part) from the consolidated Tier 1 Capital of Bank (save where such non-qualification is only as a result of any applicable limitation on the amount of such capital).

metals other than silver and gold traded on the over the counter market and may include metals traded on the London Metal Exchange, as mutually agreed between the Issuer and Bank Asya) at the spot rate.

4. Issuer will immediately sell commodities to the Purchaser (Bank Asya) on immediate delivery and deferred payment terms for an amount equal to the cost price of the Commodities to the Issuer plus an amount of profit equal to the Periodic Distribution Amounts.
5. Immediately following any purchase of Commodities by the Purchaser, the Purchaser will sell such Commodities to another commodity broker on immediate delivery and payment terms.
6. Bank Asya as Managing Director will manage the asset portfolio and it will pay the periodic distribution amount to the Issuer. Issuer will forward these amounts to the Certificateholders.
7. On the maturity date, the Issuer will require Bank Asya to purchase the Asset Portfolio and the payment of the exercise price for such purchase, together with the payment of the remaining unpaid Deferred Purchase Price pursuant to the Commodity Murabaha Agreement.

4. ISSUES AND CONCERNS

In this section, we would like to raise some issues and concerns about Basel III compliant sukuk issuances. Although, concerns stated in this section are about AT1 type issuances, they are valid for Tier 2 type of sukuk when they are relevant. This issuance trend has been praised by the stakeholders in the market since its beginning. However, there are some shortcomings have to be addressed somehow. These concerns can be classified into four categories:

a) 'Loss Absorption' Feature of AT1 Capital

Hybrid capital is capital which has certain properties of debt (eg. payments to investors are classified as interest and are thus tax deductible) but is treated as equity as far as depositors are concerned (eg. they are subordinated to depositors). Prior to the financial crisis many banks issued hybrid capital as a cost-effective means of meeting their Tier I and Tier II capital requirements. However, the financial crisis showed that many hybrid capital instruments did not absorb losses as expected, which resulted in a number of distressed banks being rescued by the public sector injecting funds in the form of common equity.

In response to this, the guidelines introduced by the Basel Committee require banks to ensure that their Additional Tier I and Tier II capital includes a mechanism for absorbing losses before taxpayers are required to bail out banks. The mechanism is colloquially known as a "bail-in" and requires that capital instruments either be written off or converted to common equity prior to the bank being rescued by taxpayers.

The implementation of Basel III accords is up to national regulatory authorities. In UAE, local version of Basel III does not include a loss absorption feature allowing regulators to convert debt into equity if an issuer faces insolvency. Because of their large state budget surpluses and lack of broad-based income taxes, Gulf governments do not see that much of a need to protect taxpayers from bank crises with loss-absorption clauses. Thus four AT1 issuances in UAE do not include loss absorption feature.

This is an important concern because some other countries' supervisory bodies require loss absorption mechanism in order to qualify an issue as high quality capital (AT1). While no Basel III-compliant instrument in the GCC has included write-down provisions on the point of non-viability or conversion into equity, Malaysian regulator Bank Negara requires loss absorption mechanisms, which could raise costs for the issuer of a subordinated sukuk, in all Basel III-compliant instruments both sukuk and bonds. Because of this reason there is no AT1 type issuance in Malaysia up to now.

b) The Cost of AT1 Capital

AT1 securities are perpetual, subordinated and equity-like instruments. They also include loss absorption feature in definition at least. All these idiosyncratic properties imply higher cost of issuing AT1 sukuk and the pricing of such a sukuk would bear a slight premium in comparison with conventional bonds. In the market so far, though, we have seen staggering demand for all AT1 issuances. Ample demand caused to squeeze spread over benchmark rates.

The cost of capital via issuing hybrid instruments may be a concern for the issuers and market participants. Issuances so far did not reflect the idiosyncratic risks of these instruments. However, it is not clear whether banks outside the supportive environment of UAE could price their hybrid sukuk so cheaply. And because of their newness, hybrid sukuk could face regulatory risk for issuers - the danger that authorities might decline to accept them as high-grade capital.

c) The “Capital Event/Tax Event” Case

However, in order for there to be the full return of capital, if there has been no “Capital Event” which would cause a write-down of the initial capital, there is a clever solution which has emerged - a mudarib has the option to indemnify the sukuk holders if the liquidated mudaraba assets are lower than the original mudaraba capital, and pay the shortfall under certain circumstances. In the courts, this type of indemnity provision is legally enforceable in the case of these outstanding sukuk they give the mudarib the right but not the obligation to make whole any shortfall in the liquidated mudaraba assets at any call date. This puts the onus on the issuer/mudarib to perform and fulfill this shortfall if any, whilst there remains a small risk where the shortfall is not covered by the mudarib and the investors are exposed. From an investor’s analysis perspective this is a slightly riskier proposition versus its conventional counterpart. However, in practice it will be highly unusual for the mudarib not to cover the shortfall as this would be a huge reputational and credit risk for future issuances. What remains to be seen is what the mudarib actually does if and when such a shortfall occurs, and more importantly what affect this has on other similar outstanding paper.

d) Shariah Governance

From an Islamic structuring perspective, AT1 sukuk has equal profit and loss-sharing features, and per certain restrictions and conditions, depending on the bank’s profitability, it allows for non-payment of profits. Further, there is no accrual feature, which most resembles a true equitable relationship. This security is senior only to common equity in ranking and payments.

In terms of structure, mudaraba agreement was used all of AT1 sukuk issuances. Sukuk Mudaraba, which is generally seen under Shariah law as a profit-and-loss sharing partnership, provides an ideal Islamic structure to accommodate the features of Additional Tier 1 capital, such as the discretionary profit payments.

According to Sairally et. al (2013), although it is called as mudaraba, it takes the ruling of musharakah. They claimed that since the proceeds of issuances were co-mingled with issuers’ assets and used for the general obligation of it, the structure became musharaka. This approach seems reasonable because in theory the rabb al-mal (issuer) in mudaraba subordinated sukuk has an ownership claim over the proportion of the assets financed by his mudaraba funds. If these contracts are treated as musharaka, the question has to be answered is whether the sharia law allows subordination among ordinary shareholders and musharaka sukuk holders. According to Basel III rules, AT1 security is senior only to common equity in ranking and payments. It means that ordinary shareholders are subordinated to AT1 security holder. In our cases, we can rephrase this problem as: if all AT1 securities classified as musharaka sukuk, how ordinary shareholders subordinated to AT1 security holders while both type of equity based on the musharaka contract.

Sairally et al (2013) states that it is impossible to give priority to one partner in receiving payments and to be subordinated as a senior vis-à-vis another partner under the musharaka contract. This rule is based on the following fundamental principal: “Profit is based on the agreement of the parties, but loss is always subject to the capital contribution [of investment]” (Al-San'ani, 1403H, 8: 248). After giving plenty amount of references, Sarially et al (2013) concluded that subordination of ordinary shareholders vis-à-vis musharakah sukuk is not possible. Moreover, they should be ranked pari passu and be treated equally in terms of loss absorption.

e) Limited Secondary Market Trading

Basel-III compliant sukuk generally have secondary market trading. However, secondary market activities are limited mainly because of ‘buy and hold’ strategy of investors in this market. As referring to the Table 4, ADIB issuance listed on London Stock Exchange and others listed on Irish Stock Exchange.

5. CONCLUSION

Basel III rules has its own characteristics which are not parallel with IFIs products and operations. This causes some problems for IFIs especially with regards to capital adequacy and liquidity requirements. To address the capital adequacy needs of Islamic banks under Basel III requirements, Basel III compliant sukuk has been innovated. According to usage of proceeds, these sukuk are called as either AT1 or T2 sukuk. According to Basel III, subordinated bonds and loans are counted as Tier 2 capital. Thus, T2 sukuk are seen as subordinated claims.

On the other hand, AT1 sukuk structures distinguish themselves from the majority of sukuk because they allow the issuers to delay periodic payment and push some of the underlying (principal) risk onto the sukuk holders. This is a far cry from the types of sukuk that attracted AAOIFI’s ire in 2008 for not having any risk sharing features.

Besides the rapid adoption of a new structure, the combination of debt and equity features is important if the sukuk market hopes to gain some differentiation between itself and the conventional bond markets. Conventional bond markets are based on interest-bearing debt, and sukuk markets have been blamed by copying this approach at least in substance if not in form. These perpetual sukuk still mimic conventional bonds in many ways, but the inclusion of equity features makes them include the type of risk sharing often promised but rarely delivered in Islamic finance. As these structures are refined, they should be made more standardized to lower issuer cost and make Islamic capital markets less debt based and more centered on hybrid solutions that better incorporate risk sharing than products in the industry’s past. The momentum is expected to pick up pace as Basel III accords are phased-in through the coming years.

Although these entire positive comments about the trend, there are some concerns that should be addressed. Firstly, ‘no loss absorption’ feature of outstanding AT1 issuances may not be an option for other countries. Since Basel III accords require loss absorption for AT1 capital, general tendency of countries is to comply with this rule. Including loss absorption property is not a problem in terms of sharia perspective. However, it may cause to increase the cost of capital for issuers which is the second concern regarding Basel III compliant sukuk trend. Third concern is about the case of capital event. Outstanding issue prospectuses state that in case of a capital event there would be a write-down of the initial capital. Mudarib has the option to indemnify the sukuk holders if the liquidated mudaraba assets are lower than the original mudaraba capital, and pay the shortfall under certain circumstances. However, it is very important to see what the mudarib actually does if and when such a shortfall occurs, and more importantly what effect this has on other similar outstanding paper. Fourth concern is regarding Shariah governance. Although AT1 sukuk were issued based on Mudaraba structure, the proceeds of issuances were co-mingled with issuers' assets and used for the general obligation of it. Some comments claim that this co-mingling process converts the structure to Musharaka. According to Basel III rules, ordinary shareholders are subordinated to AT1 security holder. If the claims stating that all AT1 securities have to be classified as musharaka sukuk are valid, the question is how ordinary shareholders subordinated to AT1 security holders while both type of equity based on the Musharaka contract. It seems that co-mingling process has to be reviewed again in order to address this important question. Limited secondary market trading of these sukuk is the last concern. However, it can be thought an important issue not only for Basel III sukuk segment but also whole sukuk market globally.

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