ISLAMIC FINANCIAL SERVICES BOARD

CAPITAL ADEQUACY REQUIREMENTS FOR *SUKŪK,* SECURITISATIONS AND REAL ESTATE INVESTMENT

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ACRONYMS

ABS	Asset-backed security
Basel II	International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Updated November 2005
CCF	Credit conversion factor
ECAI	External credit assessment institution
IAH	Investment account holders
IFSB	Islamic Financial Services Board
IFSB-2	IFSB Capital Adequacy Standard
IIFS	Institutions offering Islamic financial services
IMB	*Ijārah Muntahiyah Bittamlīk*
SPE	Special purpose entity
UIAH	Unrestricted investment account holders

Bismillahirrahmanirrahim

Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

INTRODUCTION

1. In December 2005, the Islamic Financial Services Board (IFSB) issued its Capital Adequacy Standard for institutions offering only Islamic financial services (IIFS) – hereinafter IFSB-2. Subsequently, and in the light of industry developments, the IFSB received inputs from the industry regarding issues of capital adequacy not addressed by the Standard IFSB-2 – namely, those relating to types of *sukūk* not covered by IFSB-2, to *sukūk* origination and issuance, and to investment in real estate. The IFSB decided to develop a single supplementary Standard providing guidance on these issues.

2. The Standard is intended to be applied to non-insurance IIFS. Supervisory authorities may, at their discretion, extend the requirements set out in this Standard to Islamic "window" operations that are self-contained or other relevant IIFS that fall within their jurisdictions. In addition, the risk-weighting methodology may be applied to *sukūk* and real estate investments held by Islamic "window" operations that are not self-contained or by other institutions holding such assets.

3. In the case of *sukūk*, this Standard deals with aspects of regulatory capital requirements for IIFS in respect of *sukūk* that are not covered in the IFSB-2. These aspects are the following:

(a) Capital requirements for IIFS that are *holders* of *sukūk* that do not meet the criteria set out in paragraph 193 of IFSB-2 – that is, they do not represent the holder's proportional ownership in an undivided part of an underlying asset (or pool of assets) where the holder assumes *all rights and obligations* attaching to such an asset or pool of assets, so that the requirements of section C.7 of IFSB-2 do not apply.

(b) The capital treatment of the exposures of an IIFS where it is, or acts in a capacity such that it is considered to be, the *originator* of a *sukūk* issue, or as an issuer or servicer of a *sukūk* issuance – that is, *securitisation exposures*. Essentially, this part of the Standard deals with the conditions that need to be met in order for securitisation exposures to be derecognised or minimised, and with the capital treatment of such exposures by IIFS when they occur.

4. This Standard applies to both originating and issuing IIFS (including originating IIFS that invest in their own originated *sukūk*). For *sukūk* that are traded in the secondary market, the market risk capital requirement as mentioned in IFSB-2 is applicable.

5. For real estate investment, this Standard deals primarily with the following issues:

(a) capital requirements for an IIFS that invests its own funds in real estate investment activities; and

(b) the capital treatment of exposures in real estate investment activities where an IIFS either commingles the funds of investment account holders (IAH) with those of shareholders (and other non-profit-sharing investment account holders) or otherwise invests the funds of unrestricted investment account holders (UIAH).

6. The Standard also points out the need for the authorities supervising IIFS to set forth threshold limits for IIFS having real estate investment activities and financing activities involving real estate exposures.

7. The Standard adapts the practices of various institutions in terms of prudential regulations and capital adequacy requirements regarding real estate exposures in both investment and financing activities that are set out by various countries, including IFSB member countries and the Basel Committee for Banking Supervision. It should be noted that conventional institutions have no direct exposures to real estate assets as part of their financing activities.

1. *SUKŪK* AND SECURITISATION

1.1 Definition

8. *Sukūk* (plural of *sakk*), frequently referred to as "Islamic bonds", are certificates with each *sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *muḍārabah*). These assets may be in a specific project or investment activity in accordance with *Sharī`ah* rules and principles. *Sukūk* differ from conventional interest-based securities or bonds in a number of ways,[1] including:

(a) The funds raised through the issuance of *sukūk* should be applied to investment in specified assets rather than for general unspecified purposes. This implies that identifiable assets should provide the basis for Islamic bonds (see paragraphs 25 to 27).

(b) Since the *sukūk* are based on the real underlying assets, income from the *sukūk* must be related to the purpose for which the funding is used.

(c) The *sukūk* certificate represents a proportionate ownership right over the assets in which the funds are being invested. The ownership rights are transferred, for a fixed period ending with the maturity date of the *sukūk*, from the original owner (the originator) to the *sukūk* holders.

9. Securitisation in *sukūk* is broadly referred to as a process of issuing *sukūk* involving the following steps:

(a) origination of assets (in conventional finance, these are normally loans or other receivables, while in Islamic finance they are *Sharī`ah*-compliant assets such as the subject matter of *ijārah*);

(b) transfer of the assets to a special purpose entity (SPE) which acts as the issuer by packaging them into securities (*sukūk)*; and

(c) issuing the securities to investors.

1.2 *Sukūk* structures

10. While it may initially appear that *sukūk* structures that are not based on partnership interests (*mushārakah* or *muḍārabah*) have real assets at their core, a detailed analysis of the commercial terms and legal structure shows that, in fact, any one of the three following situations may exist:

(a) An asset-backed *sukūk* structure[2] that meets the requirements for being an asset-backed structure as assessed by a recognised external credit assessment institution (ECAI): this structure would leave the holders of *sukūk* to bear any losses in case of the impairment of the assets. The applicable risks are those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI. (This is the category explicitly covered by IFSB-2.)

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[1] Please refer to Appendix 1 for a comparison between *sukūk*, conventional bonds and shares.

[2] In Islamic finance, asset-backed structures involve ownership rights in the underlying assets (either physical or the usufruct of such assets, excluding all types of receivables or debts except where these form a minority part of a pool of assets), whereas in conventional asset-backed structures the asset backing takes the form of collateral rights, not ownership rights.

(b) An asset-based *sukūk* structure[3] with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the *sukūk.* Normally, the assets are leased back to the originator in a sale-and-leaseback type of transaction. The applicable credit risk is that of the originator, subject to any *Sharī`ah*-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer (see paragraph 13). Such structures are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer.

(c) A so-called "pass-through" asset-based *sukūk* structure: a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *sukūk*. This issuing entity requires the originator to give the holders recourse, but provides *Sharī`ah*-compliant credit enhancement by guaranteeing repayment in case of default by the originator.

Of the above three categories, this Standard focuses on the last two, which are not explicitly covered in IFSB-2.[4]

11. In conventional securitisations, the structure is normally such that the originator transfers the beneficial rights in or title to the assets to the issuer on behalf of the investors, who do not hold such rights directly but have beneficial ownership through their legal relationship to the issuer. The issuer is a SPE, which should be "bankruptcy remote" from the originator in order to protect the rights of the investors in case of the insolvency of the originator.

12. In many jurisdictions, however, including some in which *Sukūk* issues may take place, there may be legal obstacles to setting up an appropriate type of SPE which can meet the conditions for the fiduciary responsibilities mentioned above. In such legal environments, it may not be possible to transfer beneficial title in the assets to the investors, or to ensure that the investors are able to exercise these rights (for example, to repossess *ijārah* assets) in case of default. In such cases, it is not feasible to create a structure for issuing non-recourse asset-backed securities (ABS).[5]

13. For *sukūk* holders, the applicable risk weights of structures in paragraph 10(b) and (c) above, where the issuance is likely to be exclusively supported by that of the originator through a repurchase undertaking, are the credit risk weight of the originator, subject to any *Sharī`ah*-compliant credit enhancement by the issuer. The applicable credit risk weights are based on credit ratings issued by a recognised ECAI (see IFSB-2, section B.1).

1.2.1 Collateral security structure

14. Consideration of the collateral security structure is a critical factor; it needs to be the subject of legal opinions and is subject to *Sharī`ah* permissibility (in the case of perfectibility). Those security interests must be the first priority (there can be no prior or subsequent claims) and perfected (or perfectible).

15. The legal opinions must address the nature of the security interest, the enforceability of the security interest against third parties, and perfection requirements (such as notices, registration and recordation). The effects of bankruptcy on perfection must also be considered and opined upon. Issues arising include:

[3] Asset-based structures in Islamic finance are found in cases where, given the applicable legal environment, the ownership rights over the underlying asset may not reliably result in an effective right of possession in case of default, and in consequence, the *sukūk* holders need to have a right of recourse to the originator in case of default.
[4] IFSB-2 deals in detail with risk weights on *sukūk* exposures when the *sukūk* are ABS involving full transfer of legal ownership of the underlying assets.
[5] In this case, if the law permits, IIFS may retain the ownership title of the assets.

(a) *Rahn* (mortgage or other pledge of assets) concepts in certain jurisdictions are possessory in nature. This makes perfection a particularly difficult opinion issue in these jurisdictions.

(b) In many jurisdictions, and without regard to *rahn* concepts, perfection and priority regimes are not well developed.

(c) Bankruptcy laws and regimes may also not be well developed in some jurisdictions.

1.2.2 *Sukūk* structure with a repurchase undertaking (binding promise)

16. In this structure, the originator enters into a repurchase undertaking (binding promise to buy the assets), according to which the assets are repurchased by the originator at maturity or upon early termination[6] if the originator has the option to call the *sukūk*. Such structures are often used in the case of *ijārah* (sale and leaseback) *sukūk* issues. Where a repurchase undertaking exists, investors have a credit exposure to the corporate or sovereign entity providing the undertaking, and an analysis of the exposure of the underlying assets becomes secondary. This gives rise to the risks of (a) the enforceability or strength of the repurchase undertaking in the jurisdiction, and (b) the ranking or priority of the *sukūk* in the capital structure of the originator. The term "pay through" is used for this type of structure when the income from the securitised assets is paid to the issuer, who passes it on to the investors (less any commission due to the issuer).

17. A commonly used *sukūk* structure with a repurchase undertaking is the sovereign *sukūk* issued by certain national monetary authorities. Both *ijārah*-based (tradable) and *salam*-based (non-tradable) *sukūk* have been issued using such a structure, with a repurchase undertaking from the national monetary authority. In such a structure, *the credit risk of the sukūk is that of the originator*. When the latter is a highly rated sovereign, the *sukūk* benefit from an investment-grade credit rating; however, achieving such a rating may be problematic for a private-sector originator.

18. A *mushārakah* structure may be used that aims at replicating asset ownership by setting up a venture (*mushārakah*) jointly owned by the *sukūk* issuer (usually incorporated as a SPE) and the originator. The issuer and originator's shareholdings in the *mushārakah* represent their respective capital contributions based on a parity agreed at the outset, usually comprised of: (a) capital from the issuer (for example, proceeds of the investors' payment for the *sukūk*); and (b) specific assets and "management skills" from the originator. Should the cash flows generated by the assets under the business plan of the *mushārakah* not be sufficient to fund these payments, subject to *Sharī`ah* permissibility, the issuer may have the option to call the repurchase undertaking on behalf of the investors.

1.2.3 Pass-through structure with no repurchase undertaking

19. This is a structure involving asset-based *sukūk* where a separate entity may act as sponsor and issuer, by purchasing the underlying assets from the originator (that is, a financial institution), packaging them into a pool and securitising the pool by issuing the *sukūk*. This sponsoring entity requires the originator to give the holders recourse, but provides *Sharī`ah*-compliant credit enhancement by guaranteeing repayment in case of default by the originator. This credit enhancement provides the *sukūk* issuance with the credit rating of the (highly rated) issuer and thus enables it to achieve an investment-grade credit rating.

[6] Basel II, paragraph 548 states the conditions that must be fulfilled for early termination. Supervisory authorities may specify the relevant conditions within their jurisdictions.

1.3 Parties in a securitisation structure

20. The parties in a securitisation structure include the originator, the issuer and the investors, in addition to which the following may be involved: one or more credit rating agencies to rate the securities (*sukūk*), an investment banker to act as an adviser or to place the securities with investors, and (in conventional securitisations) an institution that acts as a provider of credit enhancement.[7]

21. An IIFS may act as originator of *sukūk* issues in any of the following cases:

(a) The ownership of assets held by the IIFS is transferred to holders of *sukūk* by means of a securitisation. Such a securitisation may offer the IIFS one or more of the following benefits:

(i) increased liquidity, since a relatively illiquid asset (such as an asset held as lessor in an *ijārah* or *ijārah muntahiyah bittamlīk* (IMB)) is converted into cash paid by the investors in the *sukūk*; and

(ii) reduced capital requirements, insofar as the securitisation may permit the IIFS to exclude the assets from the calculation of its risk-weighted assets since they are derecognised, subject to any securitisation exposures (see sub-section 1.6 below).

The achievement of the second of these benefits will depend on the way in which the securitisation is structured. For this, the IIFS must be able to derecognise all or most of the exposures relating to the assets from its balance sheet, according to the criteria for derecognition set out in paragraphs 29 to 31.

(b) An IIFS may act as sponsor of an asset-backed *sukūk* issuance or similar programme involving assets of a customer in which the IIFS manages or acts as adviser to the programme, places the *sukūk* into the market, or provides liquidity and/or credit enhancements. In this case, the benefit to the IIFS would be the earning of fees from the services provided.

22. In a securitisation structure, the role of servicer consists of collecting payments on behalf of the investors and passing them onto the latter, when this function is not carried out by the issuer. In the case of *ijārah* or IMB assets, the lessor is legally responsible for maintaining the assets in such condition that the lessee is not deprived of the full usufruct of the assets, which involves responsibility for basic maintenance, insurance, and so forth. This function is performed on behalf of the *sukūk* holders by the servicer, but the originator may act as servicer.

1.4 IIFS' exposure to risks from various perspectives

23. As described earlier, an IIFS may act in various capacities in a *sukūk* securitisation. Its exposure to risks may be similar to that of the conventional securitisation; however, *Sharī`ah* rules and principles may add an extra dimension to the existing risk exposures and may have a material effect on the risk profile of *sukūk* holders.

[7] A credit enhancement in a securitisation is a contractual arrangement whereby an IIFS retains or assumes some part of a securitisation exposure and thereby provides some degree of added protection to the other parties. Particular care must be taken to ensure that any credit enhancement is *Sharī`ah* compliant.

24. The risk exposures of *sukūk* from various perspectives are summarised in Table 1.

Table 1: Risk Exposures from Various Perspectives

Originator	**Servicer**	**Issuer**	**SPE**	**Holder**
Risks related to repurchase undertaking (binding promise) The originator is obligated to make payments in respect of the *sukūk* or the assets in certain circumstances resulting from a breach of certain representations and warranties. The originator may need to compensate the issuer in the equivalent amount or replace the relevant assets.	**Service default** Where the underlying assets are consumer linked, there is still a dependence on the originator despite the fact that they have been sold to the *sukūk* SPE. The originator usually maintains the business "relationship" with the underlying consumers and continues to collect payments on behalf of the *sukūk* holders. In this capacity, the originator is referred to as a "servicer" and, despite satisfaction of all the regular securitisation conditions, a default of a servicer would still have an adverse effect on the *sukūk* performance.	**Default** If the originator fails to pay the coupon payments, the *sukūk* holders (or the SPE on their behalf) can declare an event of default and accelerate the principal payment obligation of the originator by compelling the originator to repurchase the asset. If the originator fails to pay the principal amount equal to the *sukūk* issue amount at the maturity of the lease term, the *sukūk* holders (or the SPE on their behalf) will have a right to take legal action against the originator. The *sukūk* holders (or the SPE on their behalf) may also have the right to sell or foreclose on the underlying assets.	**Bankruptcy** SPE is generally incorporated as a bankruptcy remote vehicle to mitigate bankruptcy risk. **Settlement** To avoid any settlement risk in relation to the SPE, all payments due from the obligor will be paid by the obligor directly to the clearinghouse, if any, which will then settle the payments directly to the *sukūk* holders.	**Liquidity** The *sukūk* holder will be subject to liquidity risk associated with the market, whether in the primary or secondary market. **Rate of return** If the underlying rentals are fixed, then IIFS holding the *sukūk* will be exposed to rate of return risk since their IAH are expecting returns reflecting a floating rate benchmark. The issuer may exercise a clean-up call,[8] and the holders of the *sukūk* being cancelled may not make the return they are expecting. **Impairment of assets** Depending on the structure, the holders of *sukūk* bear any losses in case of the impairment of the underlying assets, in the absence of negligence of the lessee.

[8] A clean-up call is a call option that permits asset-backed *sukūk* to be called before all of the capital payments due to the holders have been made. For example, this would apply when the underlying assets are IMB assets, the lease payments made by the lessee contain a purchase or capital element, and a number of lease payments remain to be made. It would generally be accomplished by the originator repurchasing the *sukūk* once the number of lease payments remaining to be made had fallen below some specified level.

1.5 Operational requirements pertaining to *sukūk* and securitisation

1.5.1 The assets in securitisations

25. The assets in the securitisation have to be in compliance with *Sharī`ah* rules and principles. Islamic finance typically relates finance to assets, and the concept of payments of income and principal being derived from *Sharī`ah*-compliant assets is prevalent in Islamic structured transactions.

26. For an IIFS, the underlying assets to be securitised may include, *inter alia*, *ijārah* leased assets, *murābahah* or *salam* receivables, *istisnā`* assets or equity ownership (*mushārakah* or *muḍārabah*) according to *Sharī`ah* rules and principles. In certain jurisdictions, the *sukūk* may also be based on a portfolio of underlying assets comprising different categories. Use of such a portfolio allows for a greater mobilisation of funds, as *murābahah* or *salam* assets that do not meet *Sharī`ah* criteria for tradability (being classed as receivables) can be combined in a portfolio with *ijārah* assets and/or with *mushārakah* or *muḍārabah* instruments that are classed as non-financial.

27. Thus, while *sukūk* based on financial assets are not tradable, the latter may be combined in a pool with non-financial assets that can act as a basis for tradable *sukūk*, provided the proportion of non-financial assets (neither debt nor cash) in the pool is not less than a certain acceptable minimum ratio, in accordance with *Sharī`ah* rules and principles.

28. Business ventures organised as *mushārakah* or *muḍārabah* partnerships may also be securitised, and the resultant *sukūk* are tradable. Where such *sukūk* are held by an IIFS until maturity and are unrated, the provisions of IFSB-2 for "equity position risk in the banking book" are applicable.

1.5.2 Recognition of risk transference (asset derecognition criteria)

29. An originating IIFS may exclude securitised exposures from the calculation of its risk-weighted assets only if all of the following conditions have been met. IIFS meeting these conditions must still hold regulatory capital against any exposures that they retain in respect of the securitisation (such as credit enhancements). It should be noted that for the reason given in (c) below, assets securitised in non-ABS securitisations would not qualify for derecognition.

(a) Substantially all credit risks (and price risk, where applicable) associated with the securitised assets have been transferred to third parties. (Please refer to paragraphs 28 to 33 on *Sharī`ah* requirements pertaining to the transfers.)

(b) The transferor (that is, originator) does not maintain effective or indirect control over the transferred assets. The assets are legally isolated from the transferor in such a way that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. These conditions must be supported by an opinion provided by qualified legal counsel. The securitised assets held by the issuer will not be consolidated with the assets of the originator or the issuer's parent in a bankruptcy or insolvency of any of those entities.

(c) Holders of the *Sukūk* (investors) have a claim only to the underlying pool of assets, and have no claim against the transferor. Hence, assets in non-ABS structures (pay-through and pass-through structures, as described in sub-section 1.2 above), would not qualify for derecognition.

(d) The immediate transferee is a SPE, and the holders of the beneficial interests in that entity have the right to pledge or exchange such interests without restriction.

(e) Clean-up calls must be at the discretion of the originating IIFS. They must not be structured to provide credit enhancement and must be exercisable only when 10% or less of the purchase consideration for the underlying assets (for example, in an IMB) remains to be paid. If a clean-up call does not meet these conditions, it will be treated as a credit enhancement by the originator and give rise to a capital charge accordingly.

30. In order to comply with *Sharī`ah* rules and principles, the structure must transfer all ownership rights in the assets from the originator via the issuer to the investors. Depending on the applicable legal system, these ownership rights do not necessarily include registered title. The transfer could be a simple collection of ownership attributes that allow the investor (a) to step into the shoes of the originator and (b) to perform (perhaps via a servicer) duties related to ownership. The transfer could also include rights granting access to the assets, subject to notice, and, in case of default, the right to take possession of the assets.[9]

31. The transfer raises questions of whether one transfers (a) the control of assets, and (b) substantial risks and rewards of ownership of the assets. For the purpose of tax, accounting and/or regulation, the derecognition of the assets from the originator's balance sheet relies on a "true sale",[10] meaning that the economic value of assets has been transferred from one party to another in a way that prevents the creditors or liquidator of the seller from claiming the assets from the buyer, thus creating "bankruptcy remoteness" for the assets. The question whether legal isolation has been achieved is to be judged by best practice standards. Differences in legal systems are to be taken into account in making this judgement.

32. From the *Sharī`ah* perspective, subject to jurists' interpretations in the jurisdiction, there are four key criteria for a transaction to be considered as a "true sale" that transfers beneficial title:

(a) The transfer must be such that it cannot be recharacterised by a court or other body as a secured loan, or otherwise be avoided in a bankruptcy or insolvency proceeding involving the originator of the assets (such as pursuant to a fraudulent transfer in anticipation of bankruptcy or a preference payment).

(b) The bankruptcy or insolvency of the originator should not affect the assets that have been transferred to the issuer/SPE. This, in turn, means that the issuer will be able to enforce collection and other rights against the source of the income (the payer) without hindrances resulting from the bankruptcy or insolvency of the originator.

(c) The transfer must then be perfectible at the election of the issuer.[11]

(d) The sale must be free and clear of all prior overriding liens.

[9] This right is comparable to the right of collateral over the assets, but the term "collateral" is inappropriate since the investors already have ownership rights over the assets. Assets may be either physical assets or the usufruct of such assets.

[10] A true sale at law is necessary in order to remove the assets from those of the originator in the event of insolvency of the originator. This is necessary to isolate the risk of the transferred assets from the credit risk of the originator of those assets.

[11] *Sharī`ah* scholars differ on the permissibility of separation of legal and equitable title to assets, and these differences raise impediments to effectuation of securitisations in certain unperfected transfer structures. If separation of legal and equitable title is not permissible, legal title would have to be transferred in a manner that satisfies all of the applicable perfection requirements (including notification of the payer).

33. In the case of bankruptcy remoteness, subject to the legal framework in the jurisdiction, the conditions include the following:

(a) If there were a bankruptcy of the issuer, the assets of the issuer would be distributed in accordance with law or a court order, rather than in accordance with the contractual arrangements involving the issuer.

(b) Separateness covenants will be required to ensure bankruptcy remoteness (as well as non-consolidation).

(c) Another provision to ensure bankruptcy remoteness relates to non-competition and bankruptcy declarations. The originator, investors, credit enhancers and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer. The issuer also provides, in both its constitutive documents and the transaction documents, not to initiate voluntary bankruptcy proceedings. The parties should seek a legal opinion from jurists in the jurisdiction concerned and ensure that these types of agreements and warranties are legally valid and enforceable.

1.6 Treatment for regulatory capital purposes of *sukūk* and securitisation exposures

34. In conventional securitisations, it is common to have a structure in which the cash flows from an underlying pool of assets are used to service at least two different stratified risk positions or *tranches* reflecting different degrees of credit risk. Junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches. A key objective of such structures is credit enhancement for the senior tranche, such that it achieves at least an investment-grade credit rating.[12]

35. This Standard is concerned with the capital treatment of exposures of an IIFS where the IIFS is the originator of a *sukūk* issuance involving one class of *sukūk* the income of which is derived from the income of underlying assets. In general, the risk weights as set out in paragraphs 21 to 27 of IFSB-2 are applicable to IIFS. One key issue for IIFS is the extent to which the exposures or obligations attaching to the underlying assets have been effectively transferred to the *sukūk* holders. A related issue is whether any types of risk other than credit risk need to be considered, such as price risk in the context of a securitisation where the underlying asset is a *salam* or *istisnā`* asset.

36. When referring to securitisations, it is customary to use the term "exposures" when referring either to (the credit risk of) assets involved in the securitisation, or to other exposures such as those resulting from credit enhancements or from acting as sponsor, issuer or servicer. In Islamic finance, in addition to credit risk there may be other exposures attaching to certain asset categories, as noted above.

37. While it is clear that the tradability of *sukūk* is often a key issue, and is of fundamental importance if an IIFS is acting as a sponsor of an asset-backed securitisation programme involving assets of a customer, this section of the Standard does not deal with the issue of whether the *sukūk*

[12] Conventional securitisations are categorised as either *traditional* or *synthetic*. In a traditional securitisation, payments to the investors depend on the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. In a synthetic securitisation, the credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or guarantees that serve to hedge the credit risk of the exposures by transferring significant credit risk to investors as holders of the securities.

satisfy the *Sharī`ah* criteria for being tradable, as this is unrelated to the capital treatment of the underlying assets by the originator.

38. The rating of *sukūk* must be from an eligible ECAI as recognised by the IIFS's supervisory authority, and must take into account the entire amount of the credit exposure of the IIFS with regard to all amounts owed to it. Where *Sharī`ah* requirements can materially affect the credit risk, these will be considered.

1.6.1 Capital requirements for IIFS as originators

Retained securitisation exposures

39. IIFS as originators are required to hold regulatory capital against all of their retained securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in ABS originated by them, and extension of a liquidity facility or credit enhancement. Repurchased securitisation exposures must be treated as retained securitisation exposures.

40. The risk-weighted asset amount of a securitisation exposure is computed by multiplying the amount of the exposure by the appropriate risk weight. For off-balance sheet exposures, IIFS must apply a credit conversion factor (CCF) and then risk-weight the resultant credit equivalent amount. Please refer to paragraphs 25 to 27 of IFSB-2.

41. Below are the proposed credit risk weights for the retained securitisation exposures where the IIFS is the originator:

Risk Weights

Rating	AAA to AA-	A+ to A-	BBB+ to BB-	B+ and below	Unrated
Risk weight	20%	50%	100%	150%	100%

Implicit support

42. When an originator provides implicit support to a securitisation, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. In other words, the existence of this implicit support restricts the derecognition of the underlying assets for capital purposes. This refers to a situation where an IIFS would meet the implicit support, if necessary, out of its own funds (that is, equity plus current account). An implicit support could not be met out of IAH funds without the consent of the IAH, as this would constitute misconduct and negligence and would give rise to other issues.[13] This would also be true of any other implicit support that is not *Sharī`ah*-compliant. In this context, the IIFS is required to disclose publicly (a) that it has provided non-contractual support and (b) the capital impact of doing so.[14]

1.6.2 Treatment of liquidity facilities

43. The liquidity facilities in certain types of *sukūk* structures are commitments from the facility provider to lend to or purchase assets from third parties if funds are needed to repay maturing *sukūk*. The need for such facilities may result from a timing mismatch between cash collections of the underlying *sukūk* assets and the scheduled payments (such as *ijārah* rental) under the programme to its holders. In this context, it is assumed the liquidity facilities comply with *Sharī`ah* rules and principles and meet operational requirements for the eligibility of a *sukūk* liquidity facility set out by the national supervisory authority. The requirements may include requiring the facility documentation to identify clearly and limit the circumstances under which it may be drawn. Subject to meeting such requirements, the proposed risk weight for liquidity facilities having a maturity of

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[13] Implicit guarantees to be met out of IAH funds would not be normal, as IAH would only consent if they would derive some *Sharī`ah*-compliant benefit from so doing, and in general benefits for providing a guarantee would not be *Sharī`ah* compliant.

[14] The provision of any such implicit support would be a matter for supervisory concern and possible action to restrain such behaviour.

less than one year is set at 20% CCF, while that for facilities with maturities exceeding one year is set at 50% CCF. However, if an external rating of the facility itself is used for risk-weighting the facility, a 100% CCF must be applied.

44. A servicer cash advance, based on *qarḍ* (interest-free loan), is an advance granted by the servicer to the SPE to ensure timely payment to the investors – for instance, in cases of timing differences between collection and payments.[15] However, it is a *Sharī`ah* requirement that such facilities remain essentially separate from the *sukūk* undertaking and that this separation be properly documented. In case of servicer cash advances, the national supervisory authority has discretion to assign a risk weight of 0% to such facilities.

1.7 Treatment of credit risk mitigation for securitisation exposures

45. The treatment applies to an IIFS that has obtained a credit risk mitigant to a securitisation exposure. Credit risk mitigants include guarantees, collateral and on-balance sheet netting or any other *Sharī`ah*-compliant credit risk mitigation as recognised by the regulatory authority. Collateral in this context is that used to mitigate the credit risk of a securitisation exposure, rather than the underlying exposures of the securitisation transaction, subject to fulfilling criteria in paragraphs 14 to 15 above.

46. Eligible collateral is limited to that recognised under the standardised approach for credit risk mitigation (IFSB-2, paragraph 36). Collateral pledged by SPEs may be recognised.

1.8 Treatment of credit enhancement provided by an issuer or originator

47. For *sukūk* with credit enhancement provided by the issuer or the originator, the risk weight is based on the credit rating of the credit enhancer.

48. Subject to *Sharī`ah* approval of the structure, an originator may retain a small equity share in a pool of securitised assets in order to provide over-collateralisation. For example, the originator of a securitisation of a pool of *ijārah* lease assets might securitise 90% of the pool and retain 10% as an equity position (first loss position)[16] – that is, a residual claim. The *sukūk* holders would be entitled to income based on 90%, and the originator based on the remaining 10%, of the rental income from the pool. However, if the rental income falls below the expected level,[17] the shortfall would be made good to the extent of the originator's first loss position based on a *hibah* (donation) agreement. Assuming that the originator derecognised the percentage of the asset that was securitised, the capital treatment of the originator's residual equity share would be either a deduction from its capital or a risk weighting of 1250%.

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[15] Such timing differences must be distinguished from *qard* (interest-free loan) made by a servicer to enhance the profit payout when the profit achieved results in a rate of return to investors that falls below a rate of return benchmark. *Qard* (interest-free loan) made for this purpose raise issues of *Sharī`ah* compliance.

[16] The term "first loss position" does not imply in this context that the originator would make good an actual loss suffered by the investors, which would not be *Sharī`ah* compliant. Rather, if the income from the assets fell below a specified level, the holder of the "first loss position" would waive its right to some or its entire percentage share (for example, 10%) of the income in favour of the investors.

[17] The expected level of rentals would be calculated taking account of the expected level of non-payment, void periods, etc.

1.9 Treatment of credit enhancement provided by a structure

49. In a *Sharī`ah*-compliant credit enhancement structure (for example, as described in paragraph 48), the different components in the structure would be risk-weighted, as set out in Basel II, paragraph 567, as shown below:

Risk Weights

Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ and below	Unrated
Risk weight	20%	50%	100%	350%	Deduction	Deduction

50. When an IIFS is required to deduct a securitisation exposure from its capital, the deduction must be taken 50% from Tier 1 and 50% from Tier 2. Deductions from capital may be calculated net of any specific provisions taken against the relevant securitisation exposures.

2. REAL ESTATE INVESTMENT

2.1 Current regulatory environment of real estate investment

51. The IFSB has observed that regulatory and/or supervisory authorities in a number of jurisdictions permit IIFS to invest in real estate directly on their balance sheets, or as part of off-balance sheet asset management activities, or indirectly through a wholly or majority-owned subsidiary. Real estate lends itself as a permissible asset class, as *Sharī`ah* rules and principles allow investment. However, there is a general concern that such investments may expose the IIFS to the effects of cyclical real estate markets.

52. Conventional financial institutions in general cannot engage in real estate investments unless they obtain consent from the regulatory authority. These institutions are required to comply with applicable capital standards, and the authority determines that the activity poses no significant risk to the depositors. They also need to have an adequate risk management process in place, and the overall financial conditions (including capital requirements) should be able to withstand potential risk associated with the holding of investment property. In most instances, the authorities require conventional institutions to establish a subsidiary to conduct the real estate investment activities, so as to place these activities in a separate corporate entity.

53. In the case of the IIFS, the IFSB has conducted its own survey, which indicated that supervisory authorities in some jurisdictions do not place any restrictions on the types of real estate investment activities in which they engage. In some cases, these activities are treated as financing and not investment. The regulatory authorities treat them as a type of mortgage, and they require them to be treated with the same regulatory credit risk treatment. Some IIFS act as property developers and/or then owners, which is normally undertaken by real estate specialists. Such investments raise supervisory issues, particularly with respect to risk management and capital adequacy.[18] In certain jurisdictions, the supervisory authorities provide more detailed guidance on the definition and classification of permitted activities.

2.2 Definition

54. Real estate assets include various types of completed and under-construction properties, as well as land used for such purposes. Real estate activity involves, among other things, the purchase, sale and development of land, and residential and non-residential buildings.

55. Investment in real estate refers to the IIFS investing its own and/or customers' funds directly in real estate assets or in real estate projects (or in partnerships in real estate or real estate projects) for commercial purposes to achieve profits from property development, or to benefit from asset price appreciation. However, the investment does not include assets held by a lessor under an IMB contract – that is, Islamic financing. Therefore, the key criterion in distinguishing between real estate investment and financing is the existence of a regular cash flow due or receivable from a customer in respect of the asset. The existence of such a cash flow signifies that the IIFS is providing financing to the customer for the asset, while the absence of such a cash flow indicates that the IIFS has invested in the asset on its own account (or in its own and its unrestricted IAH accounts). The national supervisory authority will determine the precise criteria that will govern real estate investment within its jurisdiction. In this context, the supervisory authority will provide a set of detailed criteria to which IIFS will pay attention.

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[18] IFSB Guidance on Key Elements in the Supervisory Review Process for IIFS, December 2007, paragraph 63.

56. In the context of this document, a real estate investment (as opposed to a real estate financing transaction) may fall into one of three broad categories:

(a) The activity of holding real estate at any stage of the development process, or even completed properties, where such a holding is not part of a financing transaction for a third party (such as IMB or *murābahah*).

(b) An asset holding where there is no binding promise from a third party to acquire (by *murābahah*) or to lease the asset (by IMB), and the holding period has exceeded a relatively short period such as six months (at supervisory discretion) and based on evidence of management intention.

(c) Operating *ijārah*.

57. In considering the source of funding for real estate investment, this Standard focuses on the issues raised by funding from the unrestricted investment accounts (where permitted), but not restricted investment account funds. This focus takes into account the fact that in the case of restricted investment accounts, the investors are informed about the asset allocation of their funds (see paragraph 67).

2.3 Risk exposures in real estate investment

58. Investments in real estate – that is, holding the assets – at any stage of the development process, or even completed properties, can be generally characterised as risky in that there is a high degree of variability or uncertainty of returns on invested funds, as well as a risk of a significant loss of capital. The risk is likely to be higher for properties under development compared to completed ones.

59. In the case of a non-binding promise to purchase an asset in *murābahah*, or to lease an asset under a contract of IMB, the circumstance that gives rise to the risks is the possibility of loss on disposal of such an asset, or from having a property vacant over a certain period, or from a significant drop in prices during the holding period.

60. The real estate investment exposes the unrestricted investment account holders to the same risks as those borne by the IIFS when the funds are commingled. The UIAH trust the IIFS to attain the target of maximised, safe and sustainable returns to them, and they generally have a small risk appetite. Moreover, they have no representation on the IIFS's board of directors or other representation in the management of their funds.

61. Owing to the risks outlined above, real estate investment activities are suitable for an IIFS only on a very limited scale and under restrictive conditions designed to control the various risks posed to the IIFS and its UIAH.

2.4 Treatment of investment exposures in real estate subsidiaries of IIFS

62. As mentioned earlier, conventional institutions are not permitted, in most jurisdictions, to invest commercially and directly in real estate. They may have subsidiaries that carry out such commercial activities, subject to restrictions. From a capital adequacy perspective, where an IIFS has a subsidiary through which it carries out real estate investment, its investments in the capital of such a subsidiary should be treated in the same way as an investment in a non-banking legal entity – that is, by deduction of the carrying amount of the investment from its regulatory capital if the amount is greater than 15% of its capital base.

2.5 Concentration limits of real estate investment

63. In jurisdictions where real estate investment is permissible, some supervisory authorities adopt a combined approach in limiting the risks to which the IIFS or its IAH are exposed through restricting the total amount of exposures in the sector, restricting the usage of unrestricted investment accounts or applying specific risk weights for this investment.[19]

64. Primarily, the supervisory authority needs to satisfy itself that the IIFS meets prudential requirements that allow it to engage in real estate investment activities on its own balance sheet or indirectly through a wholly or majority-owned subsidiary. The authority may, among other things, set the type of activity, the level of real estate investment suitable for the IIFS and the concentration level of risks. It may also set the financial conditions and managerial resources of the IIFS in order to ensure the IIFS's ability to support real estate investment activities, determine that the IIFS is adequately protected from litigation risk, and set robust risk management, stress testing and valuation processes, and appropriate practices with regard to the IIFS commingling its funds with those of the UIAH.

65. In this context, it is recommended that the supervisory authority include, *inter alia*, the following restrictions or prudential limits:

(a) Aggregate real estate investment exposures of 60% of regulatory capital, with a 15% limit on single real estate investment exposures. If an IIFS exceeds the aggregate limit of 60%, it shall inform the supervisory authority and submit a corrective action to reduce the aggregate exposures to an amount within the limit.

(b) As an alternative to the single limit based on regulatory capital as set out in (a) above, the supervisory authority at its discretion may apply separate limits to the investment of the IIFS's own funds and current accounts on the one hand and funds of UIAH on the other hand.

The former limit (an aggregate limit) should be a percentage of regulatory capital that is substantially lower than the aggregate limit of 60% mentioned in (a) above, while the latter limit would be a percentage of the UIAH funds that is greater than what would be implied by the aggregate 60% of regulatory capital mentioned in (a) above but low enough to limit appropriately the UIAHs' exposure to real estate (for example, 15% of UIAH funds).

(c) While no limit is proposed for the real estate financing in this Standard, IIFS and supervisory authorities should recognise that real estate financing involves exposures to the real estate asset class, which needs to be considered in conjunction with the exposure to real estate investment in order to avoid excessive risk concentrations in that asset class.

66. Notwithstanding the above recommendation on prudential limits, since different jurisdictions may have different macroeconomic, socio-economic and prudential objectives, the supervisory authority may at its discretion determine appropriate prudential limits and punitive capital requirements (that is, deduction from the capital) for over-concentration in real estate investment and financing.

[19] For conventional institutions, the normal treatment is for a bank's investment as a parent in a real estate subsidiary or affiliate to be deducted from its capital (equivalent to a 1250% risk weight if the minimum capital requirement is 8%). IIFS in some countries currently follow a similar deduction approach, but other countries apply risk weights of 100% or less (that is, treatment as credit risk) or risk weights of other assets. It should be noted that the Basel II guidelines for "other assets" appear to refer to other *financial* assets (see paragraphs 27 to 30 and 80 to 81).

67. In the case of restricted investment accounts, which are clearly for the purpose of real estate investment, there is no proposed limit on the percentage of such funds that may be invested in real estate (see paragraph 57). However, supervisory authorities may apply a limit to single exposures at their discretion.

2.6 The risk weighting of real estate investment exposures

68. IIFS are required to hold regulatory capital against all of their real estate investment exposures.[20] The risk-weighted amount of a real estate investment exposure is computed by multiplying the amount of the carrying value[21] by the appropriate risk weight.

69. Referring to the three categories of real estate investment as mentioned in paragraph 56 above, the applicable risk weights of a single investment exposure for each category are as follows:

(a) the treatment for single investment exposure is a 187.5%[22] risk weight;
(b) the treatment for an exposure due to a holding for financing purposes during the non-binding stage of the transaction is a 187.5% risk weight, as stated in IFSB-2; and
(c) the treatment of an exposure resulting from operating *ijārah* is the risk weights as mentioned in paragraph 166 of IFSB-2 (see Appendix 2, which gives an extract of this paragraph).

2.7 Valuation of real estate investment

70. The measurement of risk exposures in real estate investment is dependent on sound and proper valuations from third parties. The risks inherent in the real estate investment depend on a number of factors, including the type of property and the independent parties who will assess these investments. Therefore, it is vital that the supervisory authority satisfy itself that an IIFS has in place adequate valuation rules and proper valuation methodologies.

71. It is essential that the supervisory authority ensure that active IIFS within its jurisdiction value their property investment on a consistent basis. Otherwise, there can be no level playing field for capital adequacy treatment. In the case of assets under *murābahah* purchase orderer or *ijārah* transactions, the supervisory authority should satisfy itself on appropriate valuation to estimate the amount for which a property switches from investment to financing, or vice versa.

[20] When the standard IFSB formula for calculating the Capital Adequacy Ratio (CAR) is applied, assets financed by IAH funds are not included in computing the risk-weighted assets (RWA) in the denominator of the CAR, so that the risk weights are irrelevant. When the supervisory discretion version of the CAR formula is applied, a proportion – "alpha" – of the RWA financed by IAH funds is included in the denominator of the CAR; thus the risk weights apply only to the proportion "alpha" of the assets financed by IAH funds.
[21] See section 2.8 of this document on valuation of real estate investment.
[22] The risk weight of 187.5% is equivalent to a capital charge of 15% if the minimum capital requirement is 8%.

DEFINITIONS

The following definitions are intended to give a general understanding of the Arabic terms used in this document. The list is by no means exhaustive.

Hamish al jiddiyyah	An amount of security deposit held as collateral by the institution offering Islamic financial services (IIFS) at the point of entering into a contract, to confirm seriousness in an undertaking. The IIFS will take the amount of actual damage from the *Hamish al jiddiyyah* in case the customer breaches his undertaking.
Ijārah	An agreement made by IIFS to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An *ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *ijārah* contract.
Ijārah Muntahiyah Bittamlīk (or *Ijārah wa Iqtina'*)	An *Ijārah muntahiyah bittamlīk* is a form of lease contract that offers the lessee an option to own the asset at the end of the lease period, either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift of contract.
Istisnā`	An agreement to sell to a customer a non-existent asset that is to be manufactured or built according to the buyer's specifications and delivered on a specified future date at a predetermined selling price.
Muḍārabah	A contract between the capital provider and a skilled entrepreneur, whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the *muḍārib* (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the *muḍārabah* agreement, while losses are to be borne solely by the capital provider unless they are due to the *muḍārib* 's misconduct, negligence or breach of contracted terms.
Murābahah	A sale contract whereby the IIFS sell to a customer, at an agreed profit margin plus cost (selling price), a specified kind of asset that is already in their possession.
Mushārakah	A contract between the IIFS and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the *mushārakah* agreement, while losses are shared in proportion to each partner's share of capital.
Qarḍ	A non-interest bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of loaned funds would be repaid at the end of the period.
Rahn	A contract to pledge a specified asset as security against a debt whereby the creditor (*Murtahin*) is entitled to hold custody of the asset. In the event of default by the debtor (*Rāhin*), the creditor may sell the asset.

Salam	An agreement to purchase, at a predetermined price, a specified kind of commodity, which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyers make full payment of the purchase price upon execution of a *salam* contract. The commodity may or may not be traded over the counter or on an exchange.
Sukūk (sing.*Sakk*)	Certificates that represent a proportional undivided ownership right in tangible assets, or pool of assets that are *Sharī`ah*-compliant.
`Urbūn	An amount held as collateral by the institution offering Islamic financial services (IIFS) at the point of entering into a contract, to guarantee contract performance. The IIFS holds the right to obtain the dissolution of the contract during a certain period, otherwise, it will be considered as partial payment by the customer.

APPENDIX 1: COMPARISON BETWEEN *SUKŪK*, CONVENTIONAL BONDS AND SHARES

	Sukūk	**Bonds**	**Shares**
Nature	Not a debt of issuer but undivided ownership share in specific assets (asset-backed or asset-based) or business ventures	Debt of issuer	Ownership share in a corporation
Assets	A minimum of certain percentage of tangible assets	Generally not required	Not required
Claims	Ownership claims on the specific assets or business venture	Creditors' claims on the borrowing entity, and in some cases liens on assets	Ownership claims on the company
Security	Secured by ownership rights in the underlying assets or venture in addition to any additional collateral enhancement structure	Generally unsecured debentures except in cases such as mortgage-backed securities, collateralised debt obligations, equipment trust certificates, etc.	Unsecured
Principal and return	Not guaranteed by issuer	Guaranteed by issuer	Not guaranteed by company
Purpose	Must be issued only for *Sharī`ah*-compliant purposes	Can be issued for any purpose	Can be offered for any purpose
Trading of security	Sale of ownership interest in a specific asset or venture	Sale of a debt instrument	Sale of shares in a company
Responsibility of holders	Responsibility for defined duties relating to the underlying assets/venture limited to the extent of participation in the issue	Bondholders do not have any responsibilities for the circumstances of the issuers	Responsibility for the affairs of the company limited to the extent of holding in the company

Source: Adam Nathif and Thomas Abdulkader, *Islamic Bonds* (Euromoney, 2004), p. 54.

APPENDIX 2: CAPITAL REQUIREMENT AT VARIOUS STAGES OF THE OPERATING *IJĀRAH*

Applicable Stage of the Contract	**Credit RW**	**Market Risk Capital Charge**
Asset available for lease (prior to signing a lease (*ijārah*) contract)	Binding promise to lease (PL)* Asset acquisition cost less (a) market value of asset-fulfilling function of collateral (net of any haircuts) and (b) any *hamish al jiddiyyah* multiply by the customer's rating or by 100% RW for unrated customer.	Non-binding PL 15% capital charge (equivalent to 187.5% RW)[23] until lessee takes possession
Upon consigning a leasing contract and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of the leasing contract shall be risk-weighted according to the lessee's rating. 100% RW for an unrated lessee. less recovery value of the leased asset	The residual value will be risk-weighted at 100%
Maturity of contract term and the leased asset is returned to the IIFS	Not applicable	15% capital charge of the carrying value of the asset

** This Credit RW is applicable only when IIFS will have recourse to any hamish al jiddiyyah (security deposit held as collateral) paid by the customer, and (depending on the legal situation) may have a right to recoup from the customer any loss on leasing or disposing of the asset to a third party, after taking account of the `urbūn (earnest money held after a contract is established as collateral to guarantee contract performance).*

If the IIFS has no such right, the cost of the asset to the IIFS constitutes a market risk (as in the case of a non-binding PL), but this market risk exposure is reduced by the amount of any hamish al jiddiyyah that the IIFS has the right to retain.

[23] The risk weight of 187.5% is equivalent to a capital charge of 15% if the minimum capital requirement is 8%.