The twelve months following the collapse of Lehman Brothers have proved to be extremely challenging for the Islamic capital markets with very little activity to match the rapid rates of growth from 2004 to 2007. Islamic bond issuance increased by 49% in 2005, 153% in 2006 and 79% in 2007. This growth in Sukuk issuances was attributable to enhanced liquidity for investors, higher oil prices and a growing sentiment in favour of Islamic financing.

However, 2008 proved to be a more difficult year with the uncertainty caused by the AAOIFI statement earlier in the year (see below) and the market volatility in the second half of the year, reducing the number of international Sukuk transactions coming to the market by 66%. The expected development of a Shariah compliant securitization market has not occurred and, in 2009, we have now seen the first defaults taking place in the Sukuk market.

The future of the Islamic capital markets looks more fragile now than it has done at any time in the last five years although we may at last, see the first signs of green shoots with the success of sovereign issues by Indonesia and the Central Bank of Bahrain.

**AAOIFI statement**

Initially, the slow down in the Sukuk market in 2008 was attributed to the statement issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in February 2008. Sheikh Taqi Usmani’s commented that Wakalah-, Musharakah- and Mudarabah-based Sukuk should not use purchase undertakings with predetermined exercise prices in order to guarantee the return paid on a Sukuk at the commencement of the transaction.

This statement resulted in the need for issuers to either find assets which can be used in Ijarah-based structures or, where such assets are not easily available, to consider alternative structures.

The AAOIFI statement made a significant impact on the Islamic capital markets but its effect was probably overstated and the slow down in the number of transactions coming to the market was likely to have been caused more by the general volatility in the capital markets in 2008.

If the market in 2008 had been buoyant, the AAOIFI statement would not have impeded the growth of the market for long since the much-derided lawyers and bankers would have found innovative responses to address the concerns of the scholars. We began to see possible solutions in the form of the Villamar Sukuk issuance and the Sun Finance securitization.

The Villamar Sukuk issuance in May 2008 utilized non-recourse project finance principles to allow Sukuk Musharakah certificates to be issued without relying upon a purchase undertaking.

Following global concerns about the securitization market since the closing of the Tamweel RMBS transaction, the only other Shariah compliant securitization deal that has entered the market from the Gulf region is the Sun Finance US$1.1 billion issue in August 2008, using a true sale (asset-backed) structure.

Both transactions marked the first responses from the Islamic capital markets to the concerns raised in the AAOIFI statement in early 2008. The more fundamental financial crisis which followed shortly after the closing of the Sun Finance transaction as a result of the collapse of Lehman’s in September 2008, has meant that very few transactions have been able to access the markets and those which are generally using the simplest Sukuk structures, such as the Ijarah, do not give rise to the concerns expressed by AAOIFI.

The current view seems to be that investors may be frightened by any element of complexity or controversy and so, for the immediate future, it is unlikely that we will build on the steps taken by transactions such as Villamar and Sun Finance.

**New issues since Lehman**

In the immediate aftermath of the collapse of Lehman Brothers, it seemed that the Islamic capital markets would be unaffected by the prevailing financial crisis because of the belief that the Islamic financial markets had decoupled from the conventional markets and had not relied on the sub-prime assets or excessive leverage which caused difficulties for many conventional institutions. There was even a view that this crisis was an opportunity for Islamic finance to show the rest of the world that its model was much more attractive and if only the world adopted Islamic principles, we could avoid a repeat of the crisis.

By November 2008, it became clear that the Islamic financial markets were profoundly affected by the crisis and that little decoupling had in fact taken place from the conventional markets. Since September 2008, there have been few high profile transactions in the Islamic capital markets although a number of issuers had established both conventional and Shariah compliant medium term notes programs in readiness for a return of investor appetite at the beginning of 2009. The market has been slow to reappear, although there now appear to be signs of some green shoots.

The first positive sign was the inaugural US$650 million Sukuk issue by the Republic of Indonesia in April 2009 which was reported to have been seven times oversubscribed and priced more tightly than its conventional bond issued two months earlier.

The first international Sukuk issue from the Gulf came from the Central Bank of Bahrain in June 2009. The US$750 million Sukuk issued was also reported to have been significantly oversubscribed and to have been increased from an initial size of US$500 million in response to investor demand.

These new issues show positive signs and there are expectations of further issues in the market after the Eid holidays in October.

**Islamic finance as an alternative funding**

The international response to the financial crisis has been mostly positive for Islamic finance. Blue chip issuers who, for the first time, found that their conventional sources of funding were either closed to them or unreliable, have turned to Islamic finance as a source of...
Islamic Capital Markets Respond to the Financial Crisis (continued)

alternative funding. Their governments are reviewing their tax and regulatory legislations to ensure that such issuers are not penalized for accessing the Islamic markets rather than the conventional markets.

In Europe, London has shown the way by removing all tax barriers in its Finance Act to a UK corporate issuing an Ijarah-based Sukuk. The French government has also expressed its enthusiasm for Islamic finance by introducing tax changes and introducing a concept of trust law into its existing civil law system, with the promise of a Sukuk issue in the near future. Issuers in Germany and Italy are also actively pursuing Islamic finance opportunities while Asia, Hong Kong and Singapore are actively vying to become the Asian hub for Islamic finance.

Defaults produce more robust structures

The economic crisis has also resulted Sukuk defaults, by The Investment Dar, a Kuwait Islamic investment firm which owns 50% of Aston Martin, by East Cameron Gas, a Texan oil and gas company and, more recently, by Saad Group, a Saudi Arabian based privately owned conglomerate.

Some commentators believe that these defaults will impact the Sukuk market generally but they should be seen simply as a maturing market. An economic downturn is likely to see some Sukuk fall just as some bonds will fail in the conventional markets. What is more important is how defaults or any restructurings are managed so that investors feel that they are participating in a transparent and fair process.

The East Cameron Gas Sukuk is particularly interesting because it has raised issues as to where Sukuk holders stand in the line of creditors and even whether they are creditors or owners. The company has stated before the courts in Louisiana that there was no transfer of production revenues (“royalties”) to the special purpose issuer of the Sukuk and that the Sukuk transaction constituted a loan secured on the royalties, which the Sukuk holders must share with other creditors.

In the first case the judge dismissed this argument stating that the transfer of the revenues constituted a true sale to the special purpose issuer of the Sukuk but he has given East Cameron Gas leave to find further arguments to support its case. The decision in the first instance is therefore beneficial to Sukuk investors and the greater scrutiny that legislation or defaults will bring to Sukuk instruments will help the market to produce more robust structures in the future.

The East Cameron Gas litigation has highlighted one of the biggest structuring issues for Sukuk: are they asset-based or asset-backed? Most Sukuk in the market are asset-based where the asset is placed in the structure to generate profits that are paid to investors but, in the event of a default, the investors have no recourse to the assets and must rely instead on their contractual rights under a purchase undertaking issued, typically, by the originator of the transaction.

This is usually very clearly described in the Sukuk documentation, including the prospectus, but some investors, especially in distress situations, continue to believe that they have rights of enforcement against the assets themselves because an interest in the Sukuk grants them a share of the ownership of the asset pursuant to the definition of Sukuk issued by AAOIFI.

That ownership interest, however, is usually transferred to an interest in the proceeds generated, if any, by the exercise of the purchase undertaking. There are very few asset-backed Sukuk where the recourse of the Sukuk holders is purely to the assets.

It is likely, however, that most of the Sukuk issuances in the coming months will be Ijarah-based since that structure was not affected by the AAOIFI statement, and this will require potential issuers to have assets equal to the value of the proposed Sukuk available to be placed in the structure. The Ijarah structure also responds to the demand for simplicity by investors.

Removal of barriers

The economic downturn in 2008 has shown that the Islamic capital markets are a part of the international financial system and it is premature to speak of a decoupling from the conventional markets at this stage. Islamic capital markets are young markets that have been tested by this crisis but should emerge stronger as a result.

Many more conventional issuers in non-Muslim-majority countries are aware of the possibilities offered by funds that are subject to the requirements of the Shariah and the governments of such potential issuers are now acting to remove the tax and regulatory barriers which had impeded the growth of Islamic finance in these jurisdictions.

The pace of growth in the market is anticipated to pick up from 2010 onwards but it is likely that the rate of growth may not return quickly to the levels seen in 2004 to 2007. This can also be seen as a positive development as the market tests and considers new developments to ensure that they are compliant with the principles of Shariah and the needs of issuers and investors.\(^\text{10}\)