

Sukuk and Basel II

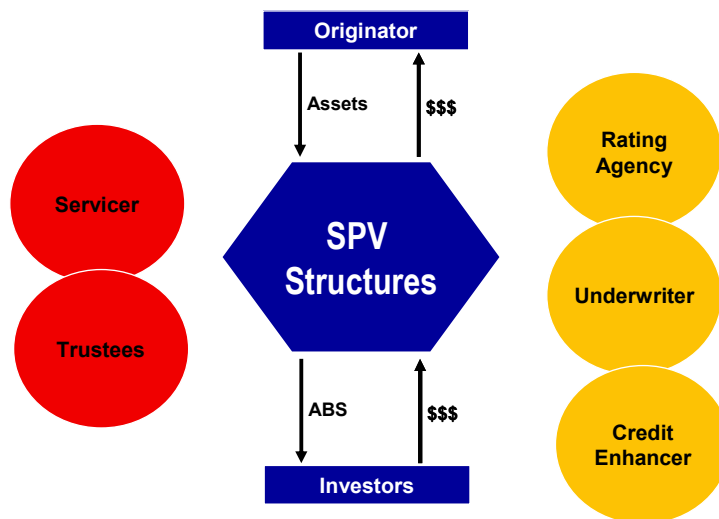
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24th January 2007



Typical Structure of an ABS/ Sukuk



Wide Spectrum of Sukuk Structures

- **Ijarah Sukuk**
 - Bahrain Monetary Agency (medium term through SPV)
 - Malaysian Government ICM (without SPV)
 - Nakheel Group (convertible option)
- **Mudaraba and Musharaka Sukuk**
 - Dubai Ports Authority (convertible option)
 - Cagamas MBS (Malaysia's National Mortgage Corporation)
- **Salam and Istisnaa**
 - Bahrain Monetary Agency (short term)
 - Bahrain Financial Harbor (Istisnaa- Ijarah)

Sukuk and Basel II

Issuing Bank
Perspective

Investing Bank
Perspective

Dependent upon the nature of Sukuk

- Is it equity?
- Is it debt?
- Is it hybrid?
- Is it securitization?

What do SPV Sukuk structures represent?

Equity ?

- Redeemable through sale of investment or liquidation
- Not an obligation on the issuer
- Residual interest on assets and income of the issuer

Debt (Finance) ?

- Guaranteed principal and profit
- Obligation of issuer
- No residual interest on assets and income of the issuer

What do SPV Sukuk structures represent?

Hybrid ?

- Unsecured, subordinated and fully paid up
- Not redeemable at the initiative of the holder without prior supervisory consent
- Available to participate in losses without the bank being obliged to cease trading
- Allow service obligations to be deferred

Asset Backed Security (ABS) ?

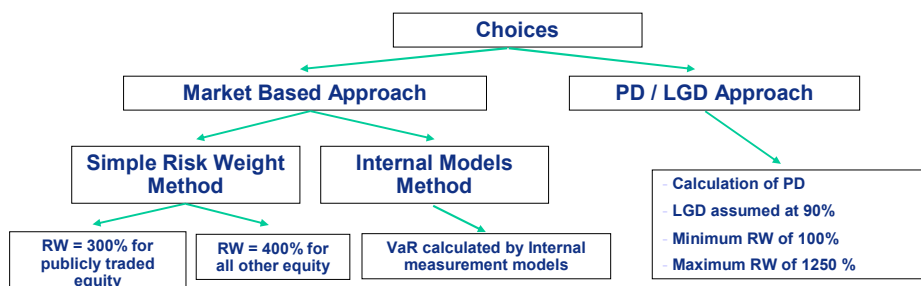
- Tranched structure in substance
- True sale of assets
- Uninterrupted rights to cash flow of the assets

Issuing Bank Perspective

- **Equity** – allowable as tier 1
- **Debt** – not allowed unless subordinated
- **Hybrid** – allowable as tier 2 if conditions met
- **Securitization** – not applicable

Investing Bank Perspective Equity, Hybrid or Subordinated Debt

- > 50% - Consolidate or carve out
- >20% <50% - Deduct from capital or pro rata consolidation
- <20% - Requirements under Standardized Approach
 - RW of 100 %, for investments in equity or regulatory capital instruments issued by banks or securities firms **unless deducted from capital**
- Requirements under IRB Approaches for Equity Exposures



Investing Bank Perspective - Debt

- Obligor can be a sovereign, bank or corporate
- Requirements under the Standardized Approach

| Sovereign | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Unrated |
|-----------|------------|----------|--------------|-----------|----------|---------|
| | 0 % | 20 % | 50 % | 100 % | 150 % | 100 % |

| Banks | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Unrated |
|----------|------------|----------|--------------|-----------|----------|---------|
| Option 1 | 20 % | 50 % | 100 % | 100 % | 150 % | 100 % |
| Option 2 | 20 % | 50 % | 50 % | 100 % | 150 % | 50 % |

| Corporates | AAA to AA- | A+ to A- | BBB+ to BB- | Below BB- | Unrated |
|------------|------------|----------|-------------|-----------|---------|
| | 20 % | 50 % | 100 % | 150 % | 100 % |

- Requirements under IRB Approaches
 $RWA = (f(PD, LGD, M)) * 12.5 * EAD$

Investing Bank Perspective - Securitization

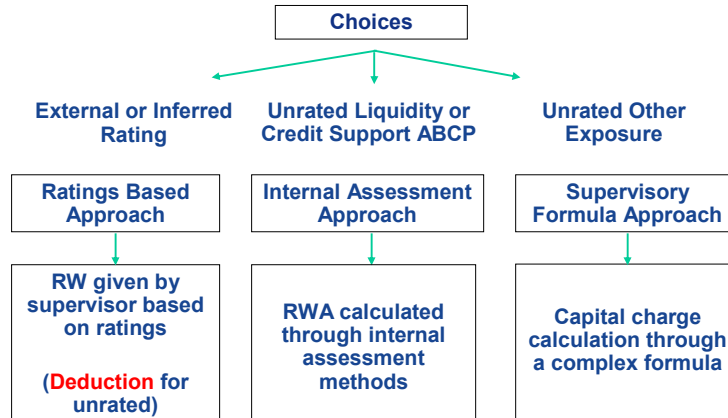
- Originating banks and investing banks
- Crucial question is rating
- Requirements under Standardised Approach

| ECA (Long-term rating category) | AAA to AA - | A + to A - | BBB + to BBB - | BB + to BB - | B + and below / unrated |
|---------------------------------|-------------|------------|----------------|--------------|---|
| Risk Weight (for investors) | 20 % | 50 % | 100 % | 350 % | Deduction (50 % from Tier 1 and 50 % from Tier 2) |
| Risk Weight (for originators) | 20 % | 50 % | 100 % | Deduction | Deduction |

| ECA (Short -term rating category) | A-1/P-1 | A-2/P-2 | A-3/P-3 | All other ratings or unrated |
|-----------------------------------|---------|---------|---------|------------------------------|
| Risk Weight | 20 % | 50 % | 100 % | Deduction |

Investing Bank Perspective - Securitization

- Requirements under the IRB Approach



Securitization – Rating is Crucial

Many issues in rating if not guaranteed by obligor (Fitch Ratings report dated 24th March 2005)

- True sale
- Non consolidation
- Bankruptcy remoteness
- Security structures
- Enforceability
- Choice of law and enforcement of judgment

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