Public Private Partnerships: lesson from Sukuk

Abdul Gahfar Ismail
Abstract

The public private partnerships are considered as the hybrid of privatization policy. It is one of a range of policies introduced by the public authority to increase the involvement of the private sector in the provision of public services. Although, there is no such reviews of this mechanism, but the public authority will continue to pursue the delivery of some public services through this means. It was introduced in 1990s. However, much of the methods of financing are clouded by conventional instruments like bonds and senior bonds. The other alternatives are to issue Islamic related instruments via sukuk. This paper will consider whether the public private partnerships will open up for new risks, using an example of KLIA projects. However, due to the underlying contracts assigned to each particular projects, it might lead to relate this public private partnerships to law origin in the issuing country. Both the risks and law origin are crucial in issuing sukuk. Hence, both may draw lessons to policymakers and players.

Keywords: public private partnership, sukuk, legal origin, risk, contracts,

JEL classifications: B81, H44, H54, H57, H81
Public Private Partnerships: Lessons from Sukuk

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1. INTRODUCTION

Initially, private finance initiative was introduced as a means of protecting infrastructure investments at a time of tight fiscal constraint. Later, it becomes an established method of procuring infrastructure by the public sector, including in the education, housing, health, transport and defence sectors. Subsequently, several studies among others are Coleshill et. al. (1998), Corner (2006), Shaoul et. al (2012) and have highlighted the advantages of private finance initiative in relation to the record of conventional public sector procurement projects, which is not good. Others such as Roe and Craig (2004) might argue that one of the benefits of its introduction has been to focus greater attention on the need to identify and manage better risks in the delivery of public sector procurement projects, not just those involving private finance. But the real success of Private Finance Initiative projects depends on the degree to which risk is genuinely transferred from the public to the private sector and optimally shared.

However, ACCA stated the following comments: The private finance initiative is:

"an extremely expensive option generated through political dogma which ought not to be necessary if central government were prepared to allow organizations to borrow money to invest"

"... PFI is a short-term quick fix, but in the longer term it is very costly to the public purse. The government itself can raise finance at the lowest rate of interest".

It is further commented by Parker (2012) who says that the financial burdens are passed into the future. It means that the next generation will be given massive liabilities from the current and past generations, to pay. Hence, the defining feature of private finance initiatives projects needs to be reformed. Roe and Craig (2004) suggested in reforming

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2It was introduced in UK and the evolution could be read in HM Treasury (2012).

3ACCA (2002). There is also an accounting issue related to sukuk, see Abd.Sukor et. al (2008)
private finance initiatives into public private partnerships, where there is no transfer of risk but is backed by government guarantee.

However, the current practice in evaluating public private partnerships is only done on the procurements, which we believe that the financing arrangements are also equally important. But, the financing arrangements are only limited to financial reporting, and partnership arrangements. Today, partnership arrangements become more complex and include a number of hybrids and pre-existing formats. Nevertheless, there are normally have similarities. The public authority will create a contract with a Special Purpose Vehicle (SPV) formed specifically to deliver a project. Here, it might be the different. In conventional way, SPV will raise the finance and the vast majority of which will take the form of senior debt, with the majority of the balance being sub-ordinated debt. A tiny amount of equity will be provided by the SPV’s owners. While, related companies, legally separate subsidiaries, will contract to deliver the construction and services elements of the projects.

To understand the realities of public private partnerships from Islamic perspective via sukuk, a distinction must be made. Although the finance for the capital expenditure comes largely from the capital providers, the contractual agreements (in this paper we refer to legal origin) between fund providers and SPV vary from debt-related contracts like murabahah, istisna or ijarah to equity-related contracts like mudarabah or musharakah.

An important message of this paper is that it is legal rights and protection under each respective contract matter for both SPV and fund providers. For example, it is the right of capital provider to share the profits of the projects under the equity-related contracts and to receive the profit margins under the debt-related contracts. But there are also the legal and financial advisors’ fees to each of the numerous parties to the transaction to structure and negotiate it.

The contracts themselves are important in the context of identifying the risks associated with public private partnerships, where the risk exposure for equity related contracts is not similar to debt related contract. Both legal origin and risk exposure have the potential to twist the successful of the public private partnerships. Because both will effect on the deliverability and efficiency of public private partnership via sukuk. Therefore, the paper focuses on the legal and risk aspects of sukuk because policy choice is mainly between different financing options: conventional or Islamic instruments, either via bonds or sukuk or different underlying contracts such as debt-related contracts like murabahah, istisna or ijarah to equity-related contracts like mudarabah or musharakah. Clearly, the economic benefits of projects will also differ in terms of benefits to originators, investors and the capital market.

The paper is organized in several sections. The second section discusses the insight into sukuk financing, especially the sukuk arrangement and categories. The third section examines the setting of sukuk structure for public private partnership. The claimed benefits of sukuk financing for public private partnership and the debate on the legal origin and risk exposure and consider what experience to date shows will be discussed in section four. Section five will conclude.

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4 Refer to FRS5, Accounting Standard Board (1998)
5 See, Moszoro and Gasiorowski (2008), hybrids such as debt or equity like.
2. AN INSIGHT INTO SUKUK FINANCING

A sukuk is a financial transaction in which assets are pooled and certificates representing interests in the pool are issued. An example would be an Islamic bank that has issued a large number of housing financing and wants to raise cash so it can issue more financing. One solution would be to sell off its existing financing, but there is no liquid secondary market for individual housing financing. Instead, the bank pools a large number of its financing and sells interests in the pool to investors via SPV which acts as a sukuk issuer. For the Islamic bank, this raises capital and removes the financing from its balance sheet, so it can issue new financing. For investors, it creates a liquid investment in a diversified pool of housing financing, which may be an attractive alternative to other Islamic financial instruments. The ultimate owners - the house owners - need not be aware of the transaction. They continue making payments on their financing, but now those payments flow to the new investors as opposed to the Islamic bank.

2.1 Sukuk Arrangement

In a typical arrangement, the owner - or "originator" - of assets sells those assets to a special purpose vehicle (SPV). This may be a trust company or some form of partnership. It is established specifically to facilitate the introduction of sukuk. It may hold the assets on its balance sheet or place them in a separate trust. In either case, it issue certificates to investors. It uses the proceeds from those certificates to pay the originator for the assets.

Most assets require the performance of on-going servicing activities. For example, with credit card receivables, monthly bills must be sent out to credit card holders; payments must be deposited, and account balances must be updated. Similar servicing must be performed with housing financing, mortgages, accounts receivable, etc. Usually, the originator is already performing servicing at the time of a securitisation, and it continues to do so after the assets have been securitised. It receives a small, on-going servicing fee for doing so. Because of that fee income, servicing rights are valuable. The originator may sell servicing rights to a third party. Whoever actually performs servicing is called the servicing agent or wakeel.

Cash flows from the assets - minus the servicing fees - flow through the SPV to sukuk holders. In some cases, there are different classes of sukuk, which participate differently in the asset cash flows. In this case, the sukuk are often called tranches. If the securitisation is structured as a pass-through, there is only one class of sukuk, and all investors participate proportionately in the net cash flows from the assets.

2.2 Categories of Sukuk

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A sukuk is issued via the securitisation process, i.e. transformation of an illiquid asset into a tradable security that gives the illiquid asset the liquidity feature by the deployment or creation of some market mechanism which allows: (i) the borrowers/issuers to have direct access to the capital market; and (ii) the lenders/investors to liquidate their positions or to opt for better investment opportunities. See further discussion in Ismail (2010) and Ismail and Shahimi (2014)
There are several standard categories of *sukuk*: Mortgage-backed *sukuk* (MBS), which are backed by mortgages (debt instruments); Asset-backed *sukuk* (ABS), which are mostly backed by assets. Each segment of the market offers unique opportunities and risks, reflecting the nature of the underlying assets and market conventions that have evolved over time.

**a. Mortgage-backed sukuk**

A mortgage-backed *sukuk* (MBS) is a securitised interest in a pool of mortgages. Instead of paying investors fixed coupons and principal, it pays out the cash flows from the pool of mortgages. The simplest form of mortgage-backed security is a mortgage pass-through. With this structure, all original cost and mark-up payments (less a servicing fee) from the pool of mortgages are passed directly to investors.

A 20-year *murabahah* residential mortgage, for example, makes a fixed payment each month until its maturity. Each payment represents a partial repayment of original cost along with mark-up. Although the scheduled payments on a mortgage are fixed from one month to the next, the cash flows to the *sukuk* holder of a mortgage pass-through are not fixed (i.e., depending on the contract). This is because mortgage holders have the option of prepaying their mortgages. When a mortgage holder exercises that option, the pre-payment is passed to investors in the pass-through. This accelerates the cash-flows to the investors, who receives the original investment early but never receives the future profit payments that would have been made on that investment.

Pooled mortgages continue to be serviced by the originator (as *wakeel*) who collects a monthly fee for doing so. This servicing fee is a fixed percentage of investment, say 0.25% annualised. The fee is subtracted from profit payments to investors. The originator may sell the rights to service the mortgages to a third party. There is a market for such servicing rights.

Prepayments introduce uncertainty into the cash flows of a mortgage pass-through. The rate at which fixed-rate mortgagors prepay is influenced by many factors. A significant factor is the level of interest rates. Mortgagors tend to prepay mortgages so they can refinance when mortgage rates drop. By acting in their own best interest, mortgagors act to the detriment of the *sukuk* holders holding the mortgage pass-through. They tend to return original cost to originator when mark-up rates are unattractive, and they tend to not do so when mark-up rates are attractive.

Risk due to uncertainty in prepayment rates is called prepayment risk. To compensate *sukuk* investors for taking pre-payment risks, pass-through offers higher profit-sharing ratios than comparable fixed income instruments without embedded options. Despite their prepayment risks, mortgage pass-through entails little credit risk.

It is also possible to segregate the cash flows from a pool of mortgages into different *sukuk* offering different maturity, risk and return characteristics. The *sukuk* can then be sold to investors with different investment objectives.

In addition to structural differences and issuer differences between mortgage-backed *sukuk*, there are profound differences that depend upon the underlying mortgages. Mortgages take many forms: single storey houses, double storey houses, 30-year fixed, 15-year fixed, adjustable rate mortgages, etc. Also, mortgage pools exhibit different
patterns of prepayment, depending upon such factors as the mortgagors' income level and geographic location. The age of mortgage collateral can also influence prepayment rates. All such factors affect the risk and pricing of mortgage-backed securities.

b. Asset-based sukuk

An asset-backed sukuk (ABS) is a securitised interest in a pool of assets. Conceptually, the structure is similar to a mortgage-backed sukuk (MBS), so it is convenient to describe the structure according to its differences from MBS.

MBS is backed by mortgages—fixed rate, residential, commercial, single storey house, double storey houses, etc. ABS is backed by non-mortgage assets. This includes school building, office buildings, bridges etc. Due to government guarantees, MBS typically entails no credit risk. ABS generally lacks such guarantees (unless the originator is government), so they entail credit risk. Due to diversification of the underlying assets, as well as credit enhancement, that risk tends to be modest. ABS can be subject to prepayment risk, but this is slight compared to that of MBS.

ABS is appealing to issuers because the structure allows them to get assets off their balance sheets, freeing up capital for further receivables. Also, ABS makes it possible for issuers whose unsecured debt is below investment grade to sell investment grade – even AAA-rated-debt. To create an ABS, a company creates a special purpose vehicle to which it sells the assets. While it is common to speak of the company as the issuer of the ABS, legally, it is the trust or special purpose vehicle that is the issuer. It issues certificates to investors. To protect investors from possible bankruptcy of the company, there are three legal safeguards: transfer of assets from the corporation is a non-recourse, true sale; investors receive a perfected in the assets’ cash flows; and a non-consolidation legal opinion is obtained certifying that assets of the trust or special purpose vehicle cannot be consolidated with the corporation's assets in the event of bankruptcy.

These same safeguards allow the company to remove the assets from its balance sheet. The corporation generally continues to service the assets – collecting revenue (e.g. lease rental and profit) and etc. It is paid out of asset cash flows for providing these ongoing services.

For investors, ABS is an alternative to highly-rated conventional corporate debt. They generally offer similar or superior liquidity. Because the underlying assets are diversified, they are less subject to credit surprises. ABS can also be structured into different classes or tranches. There may be senior or subordinated classes of debt, which have different credit ratings. Tranches may be structured with different average maturities. Choice of structure depends upon investor demand as well as the nature of the underlying assets.

3. SETTING THE SUKUK STRUCTURE FOR INFRASTRUCTURE PROJECTS

The development of Kuala Lumpur International Airport 2 (KLIA-2) is to cater the fast growing low-cost carrier airlines in the region. Malaysian Airport Holdings Bhd
(MAHB), a government linked company, has been given the authority to develop KLIA-2. It has an exclusive 25 year concession holder that operates and manages Kuala Lumpur International Airport and most of the airports in Malaysia. In 2010, it issued sukuk to finance: the construction of the KLIA-2; the MAHB’s general corporate purposes; and to refinance MAHB’s existing borrowings.

Initially, KLIA-2 project was expected to be completed by the end of the first quarter of 2012 but was amended to be completed by Jan 2013 and fully operational by April 2013. But, until this date, it does not materialize. The project is expected to have building area about 257,000 square meter and has capacity to serve up to 45 million passengers annually. The total construction cost of KLIA 2 was estimated to be around RM3.6-RM3.9 billion. While, the additional cost would be funded by internal MAHB income.

As shown in Tables 1, the sukuk is to be issued under two programmes, i.e., Islamic commercial paper programme (ICP) and Islamic medium term notes programme (IMTN). The characteristics of each programme is outlined in Row two until Row 6, Table 1. The parties involved in the issuance are reported in Table 2.

Initially the sukuk was to be issued based on Ijarah contract only. However amendment was made to the Sukuk Documents to allow issuance based on Murabahah contract. On 30 August 2010, MACB completed the issuance of the first tranche comprising RM1.0 billion nominal value IMTNs under the Shariah principle of Ijarah pursuant to the IMTN Programme. The IMTNs issued under the first tranche have a tenure of ten (10) years from the date of issuance with a periodic distribution (coupon) rate of 4.55% per annum.

On 17 December 2010, MACB completed the issuance of the second tranche comprising RM1.5 billion nominal value IMTNs pursuant to the IMTN Programme based on the Shariah Principle of Commodity Murabahah. The IMTNs issued under the second tranche have a tenure of twelve (12) years from the date of issuance with a periodic distribution (coupon) rate of 4.68% per annum.
### Table 1: KLIA Sukuk program

<table>
<thead>
<tr>
<th>Item</th>
<th>Islamic Commercial Paper Programme (ICP)</th>
<th>Islamic Medium-Term Notes Programme (IMTN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue size</td>
<td>both ICP and IMTN have an aggregate combined nominal value of up to RM5.1 billion with a sublimit of RM1.0 billion for the ICP Programme.</td>
<td></td>
</tr>
<tr>
<td>Issue Price</td>
<td>issued at a discount to face value</td>
<td>issued at par, at a premium or discount to face value</td>
</tr>
<tr>
<td>Tenure</td>
<td>7 years until 2017</td>
<td>Max 15 years until 2025</td>
</tr>
<tr>
<td>Mode of issue</td>
<td>via bought deal / book building / a competitive tender / direct placement on a best effort basis</td>
<td>via bought deal / book building / direct placement on a best effort basis</td>
</tr>
<tr>
<td>Listing Status</td>
<td>will not be listed</td>
<td>listed on Bursa Malaysia Securities Berhad (Exempt Regime) or any other stock exchange</td>
</tr>
</tbody>
</table>

### Table 2: Parties Involved in issuance

<table>
<thead>
<tr>
<th>Originator/Obligor</th>
<th>Malaysia Airport Holding Bhd (MAHB)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Incorporated on 28 Jun 1999 and a public company limited by shares — holding company of MAHB Group’s operation.</td>
</tr>
<tr>
<td></td>
<td>• Principle activity — investment holding</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issuer (SPV)</th>
<th>Malaysia Airport Capital Bhd (MACB)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Incorporated on 2 July 2010 a wholly-owned subsidiary of MAHE.</td>
</tr>
<tr>
<td></td>
<td>• Principle activity — undertake the issuance of ICP &amp; IMTN programs (Shariah principles) in connection with MAHE. It has no other operation.</td>
</tr>
</tbody>
</table>

| Joint Lead Arranger/Manager | CIMB Investment Bank Berhad / Citibank Berhad |

| Joint Shariah Adviser | CIMB Investment Bank Berhad / Citibank Berhad (backed by Shariah Committee of CIMB Islamic and Citibank Berhad) |
The operational flow of this sukuk is given in Diagram 1.

The flow involves the following steps:

1. MACB is set up as SPV (issuer). MAHB (as originator) and MACB from time to time execute asset purchase agreement by way of transfer beneficial ownership. MACB will hold the Assets in trusts for the sukukholders.
2. MACB issue sukuk to the sukukholders. The proceeds from the sukuk will be used by the MACB to purchase the Assets from MAHB.
3. MACB will lease the Assets to MAHB based on ijarah agreement for a specific lease term in return for periodic / one-off ijarah payment.
4. MAHB will pay rentals due under the ijarah agreement to MACB.
5. MACB will make distributions to sukukholders equivalent to the ijarah rental received from MAHB. On maturity date, event of default/dissolution event or mandatory redemption event, MAHB, as the obligor, shall purchase the Assets.

As mentioned earlier, the proceed from this issuance was used to pay: the construction of the new KLIA-2; the MAHB’s general corporate purposes; and to refinance MAHB’s existing borrowings. Hence, the transaction of the above sukuk also involves the buying and selling of commodity for generating cash flow to the SPV.
The explanation of Diagram 2 is as follows:

1. Investors subscribe to the Sukuk issued by an SPV; SPV declares a trust in favor of investors
2. SPV issues undertaking to purchase from MAHB
3. SPV purchases commodities (e.g. copper) from the commodity broker on a spot basis
4. MACB issues sukuk
5. SPV sells commodities on a murabahah (deferred payment – principal + profit) basis to MAHB. In case of a fixed rate issue, the tenor of the murabahah would be the tenor of the Sukuk. In case of floating rate, the tenor would be 6 months (assuming semi-annual profit payments). In both cases, profit amount would be fixed.
6. MAHB would immediately sell purchased commodity back to the broker, realizing the cash principal of the Sukuk
7. MAHB make a payment (purchase price + profit) to SPV

4. LESSONS FROM ISSUING SUKUK FOR PUBLIC PRIVATE PARTNERSHIP

In this section, we will examine the claimed benefits of sukuk financing for public private partnership. Then, the debate will be focused on the legal origin and risk exposure and consider what experience to date shows.
4.1 BENEFITS OF SUKUK

The introduction of *sukuk* offers many benefits to originators, investors and the capital market. Some of these benefits include:

a. *Originators*

   (i) Lower cost of funds due to higher rating via credit enhancement

   It is a clear proposition that the stronger the security rights of the creditor, the lesser is the risk he faces, and the lower, therefore, is the risk premium he translates into cost of financing. If securitisation means lower credit risks for the originator, obviously this should lead to lower funding costs.

   (ii) Access to the capital markets via transformation of illiquid assets into liquid and tradeable capital market instruments

   Securitisation permits companies to obtain funding directly through the capital markets. This is achieved because the financial assets are turned into certificates and sold to investors.

   (iii) Diversification of funding sources

   Securitisation provides an alternative source of capital from bank debts or debts provided by other financial institutions. Using securitisation will make originators less dependant on one source of capital. Investors of securitised certificates are usually different from investors in corporate debt and equity and from providers of corporate credit.

   (iv) Improvement of financial ratios

   Securitisation can help improve financial ratios because it removes both assets and liabilities from the balance sheet. Following securitisation, an originator's return on equity, debt to equity and return on assets ratios will improve.

   (v) Off-balance sheet finance

   Traditional forms of financing involve injection of debt or equity, which gets reflected on the balance sheet. Securitisation does neither since it provides funding through the sale of the financial assets to the capital markets. Hence, it facilitates removal of assets from the balance sheet, i.e. off-balance sheet treatment of debt resulting in improved gearing, and more efficient use of regulatory capital.

   (vi) Potential risk reduction
Securitisation transfers credit risks associated with the securitised assets. If desired, through credit enhancement, an originator may transfer substantially all of the risks associated with the assets and receive full or almost full payment of the purchase price up front.

(vii) Potential anonymity of financing

Through a multi-seller securitisation conduit, a company can access the capital markets anonymously and keep the size of a transaction private. Such information can be important for numerous reasons including, without limitation, competitive purposes.

(viii) Potential capital tax relief

Federal and provincial capital and large company taxes are based on liabilities appearing on a company's balance sheet. Since securitisation involves taking assets and liabilities off-balance sheet, potential tax savings may result.

b. Investors

The benefits that are derived from securitisation are often seen from the perspective of the originator. However, real benefits exist for the investors as well, including:

(i) High quality investment

*Sukuk* is typically rated higher - the same as Government of Malaysia *sukuk* and higher than commercial paper. Thus *sukuk* provides investors with a "safe harbour" investment product as an alternative to treasury bills at a time when federal issuance is decreasing. There has never been a downgrade or default of *sukuk* in Malaysia so far.

(ii) Better risk – reward relationship

The profit-sharing contract is normally used in issuing *sukuk*. The contracts are based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into *sukuk* terms, the originator, issuer and investors should all share the risks and the rewards of financing business ventures.

(iii) Diversification

Having a representative component of asset-backed securities in a fixed-income portfolio provides diversification by type of fixed income product within the fixed-income portfolio. Most asset-backed securities are backed by a pool of assets that is chosen on the basis of the diversification of its underlying obligors and geographical and industry diversification. Accordingly, generally, each asset-backed security is supported by a diverse pool of assets.
Securitisation provides a variety of product choices at attractive spreads that attract a diversified investor profile, i.e., variety and flexibility of credit, maturity and payment structures and terms via securitisation techniques that allow investment products to be tailored to meet specific investor needs. In addition, owning sukuk issued by a multi-seller, multi-asset conduit provides even more diversification of assets because the sukuk is backed by different kinds of pools of assets, each of which in turn is chosen for its diversity of characteristics.

(iv) Reduction of event risks

Securitisation is predicated upon eliminating the connection between the Trust's right to asset cash flows and the fund provider condition of the originator. Following a "true sale" of assets, the fund provider of the originator should not be able to make a claim against the cash flow generated by the assets. Accordingly, in evaluating the quality of the sukuk, an investor need not be concerned about events risk associated with the originator, such as industry competition, litigation, etc. Instead, quality is determined by analysing likely asset performance on the basis of historical delinquencies, defaults and losses, pooled diversification and the credit enhancement available. This sort of analysis is not subject to as many variables and is, therefore, more precise.

(v) Liquidity

Sukuk affords investors a high degree of liquidity without being locked into long term commitments, such as those found in term notes or traditional government bonds. Sukuk may be liquidated easily due to having various terms from as long as equal to the rental period to as short as per agreed upon the signing period.

c. Capital market

The capital market may get the benefits from: the establishment of secondary securitisation markets for benchmark purposes; facilitates and promotes efficient allocation of capital; and reduction of risks within the banking system.

4.2 Legal Origin and Enforceability of Sukuk Contracts

The studies done by La Porta et al. (1997, 1998) and Ismail and Tohirin (2010) show that law origin is associated with efficiency level of financial institutions since the well-developed law origin will enhance the enforcement of financial contracts. Basically, the English, French, Germany and Scandinavian civil traditions and also the common law have spread around the world via several mechanisms such as conquest, imperialism; globalization, trading and more politely like adaptation. Only recently, shariah law was implemented in the financial institutions. Therefore, legal environment varies from country to country. Therefore, the development of sukuk also varies across countries.

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^8 Via imperialism, the conqueror might establish financial institution in other countries and adopted the law of host country, for example, the establishment of Standard Chartered (Malaysia) in 1881.
depending on the legal origin. Under the civil law, as practiced in UK, sukuk fall under the definition of a Collective Investment Scheme (‘CIS’) as pursuant to the Financial Services and Markets Act (FSMA 2000). Therefore, if sukuk are considered in the same way as CIS, issuers would be subject to a wider range of controls, and may need an authorisation. Such authorisation would entail limits on the range of assets eligible for investments, gearing and marketing purposes. Hence, this would arguably put sukuk issuers at a disadvantage compared to issuers of conventional debt securities.

While, in other jurisdiction, as mentioned in Abdel-Khaleq and Richardson (2007), the United States Securities Act of 1933 (the law) does not distinguish between conventional and Islamic financial instruments. The sukuk can also be structured to take the advantage of the safe harbours from registration provided by Rule 144A or Regulation S in relation to international secured financing through private placement in US. This can be seen in the sukuk issued by East Cameron Gas in the US through private placement, whereby there was a proper due-diligence conducted over the project - oil drilling - along with risk management mechanisms for project’s anticipated risks. Hence, the law provides an impetus for sukuk development towards the true value, even though the law treats sukuk in similar fashion with conventional bonds.

In Malaysia, with effect from 1 July 2000, the proposal to issue, offer for subscription or purchase, or make an invitation to subscribe for or purchase (issue, offer or make an invitation) Islamic securities or sukuk, is done under section 212 of the Capital Markets and Services Act 2007 (CMSA). It is further strengthened with the introduction of Islamic Securities Guidelines (Sukuk Guidelines) on August 2011. This comprehensive guidelines cover the sharing rulings applicable on all types of sukuk or shariah rulings on a particular types of sukuk and disclosure requirements.

Enforceability becomes another issue. It covers: first, the dispute between civil or common law and shari‘ah law. In any particular jurisdiction, the kind of conflicts may happen due to dual system that governs the financial transactions. The conflicts may also happen which law may prevail when there are disputes. However, as stated in the Islamic Financial Services Act 2013 of Malaysia, any disputes happen in the Islamic financial institutions and markets, the National Shariah Advisory Council will be the last authority. However, it does not happen in the case of Shamil Islamic Bank of Bahrain VS Pharmaceutical Company (Practical Law Company, 2012). In that case, the defendant was not able to make payment for his financing to the bank, and the court made a decision based on English law instead of shariah law. The defendants argued that the contract was worded with Shari‘ah principles. Therefore it does not clash with English law. However, the judge ruled that there could not be two different law origin to govern a contract, and that the national system is the valid law to govern the contract based on Roman conventions which have force in the British law system. The conflict between common law and shariah leads to peculiarities, such as that verdict which was decided based on sale contract law, while the substance of the contract was actually a conventional debt contract. Therefore, the confusion emerges as to the legal basis of the verdict.

Second, trues sale execution. The execution of a true sale is an important element in sukuk transaction, as it constitutes a real transfer of ownership from the originator to the sukuk holders via the SPV. Nevertheless, some sukuk issuances do not execute a true sale, as with asset-based sukuk issuance, due to the absence of property and bankruptcy
acts under civil law origin. This was reflected in the *Nakheel Sukuk* case wherein leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE as applicable in the Emirate of Dubai (Salah, 2010, p.10). Instead, the rights were viewed as unregistered personal contractual rights which binds the contracting parties as opposed to rights to the land in question. This indicates that the civil law origin may hinder the undertaking of true sales that would be enforceable in sukuks issuance.

*Third, bankruptcy.* Bankruptcy law is crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed sukuks, even in cases of the originator’s bankruptcy.

*Fourth, Special Purpose Vehicle.* A SPV is a remote firm, which is independent from the obligor. The SPV is established based on the trust law in which the sukuks originator as the transferor transfers the assets to the sukuks holders as beneficiaries via the SPV as a trustee with a good faith. Therefore, trust law plays an important role in governing the SPV’s establishment. Trust law has been well incorporated into both common and civil law jurisdictions. This trust law recognises the equity for remedies and rights in which beneficiaries are provided with equitable treatment remedies against unfaithful acts. Within common law treatment, the legal rights of the trustee are bounded by the legal rights of beneficiaries. In contrast, under civil law treatment, the beneficiaries have no rights or control towards the assets managed by trustee. Hence, civil law treatment entails a problem for sukuks issuance that originates from civil law jurisdiction countries. In those cases, in the event of default, the sukuks holders do not have recourse to the asset due to civil law restrictions, and therefore those sukuks are characterised as asset-based sukuks. However, for mudarabah and musharakah sukuks, the trust elements are embedded in those underlying contracts.

### 4.3 Risk Transfer, Credit Risk and Evidence of Risks to Respective Parties

When assets are transferred from the originator to the SPV, it is critical that this is done as a legal sale. If the originator retains some claim on those assets, there would be a risk that creditors of the originator might try to seize the assets in a bankruptcy proceeding. If a securitisation is also correctly implemented, investors face no credit risk from the originator. They also face no credit risk from the SPV, which serves merely as a conduit for cash flows. Whatever cash flows the SPV receives from the collateral are passed along to investors and whatever party who provides the supporting services.

Depending on the nature of the assets, it may or may not pose credit risk. For example, people may fail to make their credit card payments, so credit card receivables entail credit risk. On the other hand, many assets-backed certificates have little or no credit risk. The government guarantee timely payment of original cost and mark-up on its asset pass-through. The certificate is backed by the full faith and credit of the Malaysian government, so the pass-through is free of credit risk.

If asset entails credit risk, a securitisation will often be structured with some sort of credit enhancement. This may include a third party guarantee (such as an appointment of a trustee), or other enhancements. Also, by their nature, securitisations diversify the default risk of the underlying assets.
Credit ratings are often obtained for those securitisations that entail credit risk, and most ratings are of investment grade. If a securitisation has different classes of sukuk, each may receive a different credit rating. Credit ratings can be misleading for novices. The fact that a securitisation has a AAA rating does not mean it is risk free. It only means that the chance of a sukuk holder incurring a loss attributable to default on the underlying assets is remote. Other risks, which can affect the timing of payments, may be considerable. Also, because valuing the underlying assets is often difficult, there is a risk that an investor will overpay for a securitisation the investor is ill-equipped to value on its own.

However, the evidence of risk may exist for public private partnership like sukuk KLIA 2. We will discuss the risk with respect to respective parties:

**MACB - Special Purpose Vehicle (SPV)**

- This company was incorporated with limited liability on 2 July 2010. It has no operating history.
- The Issuer will not engage in any business activity other than the issuance of Ringgit-denominated Sukuk.
- The Issuer will have no material assets other than the beneficial interests in the Assets relating to the Sukuk held by the Issuer on behalf of the Sukukholders.
- The Issuer’s principal source of funds will be its entitlement to receive rentals.

**The Issuer’s ability to meet its obligations under the Sukuk**

- The Sukuk constitute direct, unconditional and unsecured obligations of the Issuer.
- The ability of the Issuer to pay the amounts due on the Sukuk will ultimately be dependent upon receipt by the Issuer of all amounts due to it from MAHB.
- There is no assurance that there will be sufficient cash flows to meet payments under the Sukuk.

**Risk related to MAHB**

i. General risks relating to the business:

- Air traffic levels;
- Terrorist attacks;
- Natural disasters;
- Business strategy;
- Increase in international aviation fuel prices;
- Global economic and financial crisis;
- High dependence on revenue from KLIA;
- Dependence on key airline service providers;
- Dependence on key management team and key personnel;
- Rental of real property and commercial space;
- Dependence on third party services;
- Coverage of insurance policies;
- Relations with labour force;
- Construction of KLIA-2 or other land development or construction projects;
- Competition;
- Operation of airports;
- Credit risks;
- Passenger charges; and
- Operational and systems risks;

ii. Risks relating to the regulation of the business of the MAHB
- Flexibility in managing aeronautical activities;
- New Operating Agreements; and
- Environmental laws and other regulations

iii. Risks relating to MAHB
- Special Shareholder; and
- Short take-off and landing (STOL) ports.

Risk related to sukuk

i. Performance of contractual obligations (rental payments) - will depend upon the due performance by MAHB
ii. May be adversely affected by a total loss event (destruction or damage to the Asset) – mitigated by the substitution undertaking.
iii. Market value may be subject to fluctuations - numerous factors, including the operating results and/or financial condition of the Issuer and/or the MAHB Group, political, economic, financial and any other factors.
iv. The ratings of the Sukuk may be changed at any time and this may adversely affect the market value of the Sukuk;

Risk related to underlying assets

i. The purchase price paid by the issuer for the assets may not reflect the current market value - value of the assets at cost or at a premium does not exceed 1.33 times of the book value or at a discount of not less than 0.67 times of the book value of the assets. The current market value of the assets may be higher or lower than the purchase price paid by MAHB and the purchase price paid by the issuer
ii. The Issuer has not made searches and investigations relating to the assets - no investigation or enquiry will be made and no due diligence will be conducted in respect of any assets and its precise terms. No steps will be taken to perfect any transfer of the assets

5. ISSUES FOR FURTHER DISCUSSION

There are several issues which might lead for further discussion. First, the use LIBOR or KLIBOR as a benchmark – too much reliance on LIBOR or KLIBOR plus profit margin
based might be further argued. In Sukuk ijarah the profit margin determination should be based on the underlying assets. This situation clearly indicates the use of the assets underlying the sukuk issuance is a 'trick' solely for the objective legitimizing the sukuk transactions.

Second, rating of sukuk using conventional method – based on creditworthiness of issuer instead of the underlying assets. Third, the exercise price at maturity has been agreed up-front as equal to the outstanding nominal value plus all accrued but unpaid rental payment – potential loss to seller or buyer if the value of assets appreciate or depreciate at maturity. It might be eliminated by Tanazul (Waiver of Right) where for example a partner may waive his right on the profit payment from the musharakah venture, if he so desires.

Fourth, purchase by seller at maturity forced by a Purchase Undertaking; merely promise to purchase in order to give confidence to the sukuk holder. MAHB’s ability to honor the commitment depends on the credit rating. Fifth, uncertainty on the halal status of rental income (for example, selling of liquor and tobacco) – mitigated by guidelines issues by Securities Commission of Malaysia for non-compliant assets for non-halal income which is not more than 20%. Sixth, MAHB is not fully the owner of airport. It is only concession holder. Can MAHB sells the asset to others? Yes, the selling is only the beneficiary ownership but not legal ownership. In case of default, investor can only sell their beneficiary ownership, not fully asset (legal and beneficial ownership).

6. CONCLUSIONS

This aim of this paper is to examine the legal and other risks that can be derived from sukuk and to draw some lessons to policy makers on the financing options for public private partnership. By analyzing an example of KLIA projects, we found that first, sukuk offer many benefits to originators, investors and capital market; second, legal origin and the enforcement of the law are two important factors that might lead sukuk as an efficient instrument for public private partnership; third, the evidence of risk for sukuk shows that it needs to be mitigated, and could not be transferred.
References


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