

Islamic finance - issues with securitization



Chapter 1

1. INTRODUCTION

Allah has created people to know Him and worship Him, in observance of His due lordship and divinity. That is why Islam made devotion to Allah the primary requirement of a Muslim after the two witnesses [of No God but Allah, and Mohammad is His Prophet]. Transactions are part of the religious issues that a Muslim performs for the sake of Allah Most High. Every Muslim was keen on having the best conduct in transacting within their effort to get closer to Allah Most High, and to fulfill the best life structure for mankind (Does He who created not know, while He is the Subtle, the Acquainted?)[1].

One of the distinctive characteristics of the nature of transactions, and economy in general and Islamic economy in particular, was its ability to expand, renovate and develop. It has unique flexibility that can accommodate new issues and questions revolving about the needs of people, or the requirements of their transactions. Financial transactions are one of the most important aspects of daily life. They are increasingly active and developing. The forms of doing such transactions are renewed and developed in accordance with modern life activity. One of the latest and most prominent developments was the appearance of securitization process among the financial organizations worldwide.

Lots of discussion is held at present about securitization, which means the conversion of illiquid assets to financial papers. In reality, securitization is a modern financial instrument that had initially started in the US, in particular. Many American banks worked hard to securitize their debts. Even though

securitization originated in the Western World, Islam does not prohibit us from benefiting from non-Muslim inventions, so long as these inventions do not contradict with the basics of Islamic law and its roots. Interestingly, Islam was ahead of the West in using the securitization as a document to prove some right. *Al-Nawawi* discussed this issue, and declared “ *As-Sukak*” is a plural of “ *Sak*”; it is a written document in proof of a debt. The plural can also be “ *Sukuk*”. It refers to the document issued by a guardian ordering provisions, of food or others, to entitled holders. The holder may sell this document to others before getting the prescribed provisions (Al-Nawawi, Abu-Zakariyya Yahya M. 1971) [43].

In securitization, special purpose company is one of the important components of such process. This type of company appears with the securitization process, and plays a critical role in that process. Accordingly, in this dissertation the researcher endeavors to know the legal position of such a company and to identify the legal Islamic ruling related to such a company based on its nature, function and relationship with other components of the securitization process.

2. THE IMPORTANCE OF THE STUDY

This topic has its own scientific and practical importance from a scientific perspective. The special purpose company (SPC) is still a hot topic under discussion. The major issue relates to its legal position in the Islamic law. There are still controversy around its nature and function. Securitization is one of the troubling issues around the world.

From a practical perspective, the researcher posits that the concept of securitization in general and special purpose company in particular has entered all aspects of economic and societal life, while related transactions have spread in many countries, and hence become part-and-parcel of some banking financial instruments . Accordingly, knowledge of the concept of this type of company and its function becomes a communal obligation on every Muslim. Muslims should be well informed about such type of companies. If they are legally permissible, then he can deal with them with confidence; otherwise, a Muslim should turn away from such a company so long as he has the option. In case Muslims find that they are legally prohibited and find themselves forced to deal with them, the least they can do is express their discontent of such sort of companies or hold an ideology of rejecting them.

This process of inquiry into business-related legal matters is a must in a Muslim's life. This commitment cannot happen without the knowledge of the Islamic position of everything a Muslim deals with in his/her life, even where he/she does not have the option.

3. THE RESEARCH QUESTIONS

The research question lies down in presenting the concept of the special purpose company, and shows its impact on the issuance of Islamic financial products and more specifically Sukuk. The researcher will try in this dissertation to answer the following questions:

First: What is the special purpose company, and what are the reasons behind its appearance?

Second: What are the characteristics of the special purpose company, and what are its types?

Third: What is securitization, its pillars and importance?

Fourth: What is the importance of the special purpose company in the securitization process?

Fifth: What function does the special purpose company play in the securitization process and the structuring of Islamic Financial products?

Sixth: What is the legal jurisprudence and Shari'ah objective position on the special purpose company?

4. THE GOALS OF THE STUDY

In accordance with the above, I have selected this topic in order to achieve certain goals, the most important of which are:

1. To show the concept of the special purpose company and the reasons behind its emergence.
2. To expose the characteristics of the special purpose company and its types.
3. To exert best effort to research the concept of the securitization process, and show its importance and major financing components.
4. To show the importance of the special purpose company in the securitization process.
5. To present the jurisprudential position and Shari'ah objectives of the special purpose company (SPC) in modern Islamic finance products structuring.

5. PREVIOUS STUDIES

As the topic is still rather new, I could not put my hands on some in-depth scientific research on the subject, except some on securitization and SPV in general. The most important of these studies were:

- *Al-Tawreeq wa Mada Ahmmyatahu fi Dhil Qanoon Al-Rahn Al-Aqari* [Translated as: Securitization and its importance in relation to the real estate mortgage] (Al-Hijazi, Obaid Ali Ahmad 2001) [44]. The author defined securitization, its components, development and importance. The author has briefly revealed the role of special purpose companies in the securitization process. The dissertation was limited to some restricted real estate application and lacks the *Shari'ah* viewpoint.
- *Dawr Al-Sukuk Al-Islamiyah Fi Tamweel Al-Mashroo'at Al-Tanmawiyah* [Translated as: The role of Islamic Sukuk in financing development projects] (Mohammed Saleh and Fath- Al-Rahman Ali, 2008),. This research, presented at the Islamic Banking Symposium, covered the concept of Islamic securitization and its role in mobilizing financial resources in order to finance development projects. It also covered the risks inherited in these sukuk and how to manage them. The author has briefly touched on the relationship arrangement among the parties to these Sukuk. The dissertation was more specific to the Sukuk from *Shari'ah* viewpoint and did not discuss the SPV role in these structures.
- *Al-Tawriq wa Baqiyat Adawat Al-Suyoolah li-sook Al-Islamiyah* [Securitization and the rest of liquidity instruments for Islamic market] (Mala'ekah, Saleh 2005) . This study has touched on the concept of securitization and its Islamic ruling. It has further touched on the role

of Al-Tawfeeq and Al-Ameen companies in the field of mutual funds securitization. At the end of the study, the researcher elaborated on some of the securitization problems. The study lacks in-depth analysis to the modern practice in today's contemporary Islamic banking products.

- *Al-Sukuk Al-Islamiyah wa Tatbeeqatiha Al-Moa'sirah wa Tadawuliha* [Islamic Securitization, and its modern applications and trading] (Muheisen, Fouad Mohammed Ahmad 2009). The researcher expounded therein on the securitization concept, its goals, motives, and the jurisprudential rules for contemporary securitization process together with its Islamic legal controls. Also, the researcher showed the parties to securitization process, and made a comparison between the traditional securitizations and Islamic ones but lacks the analysis of the SPV role in the Sukuk Structures.
- *Al-Taskik wa Dawruhu fi Sooq Maliyah Islamiyah* [Securitization and its role in the development of an Islamic Financial Market] (Bani Amer, Zaherah Ali Mohammed 2008). In this study, the researcher elaborated on the concept of international markets and traditional securitization and its components. The researcher also presented Islamic securitization in a good way in this study.

1. 5. 1 What makes this study different?

In general, previous studies were concerned with historical precedence, details and comments on the securitization process in order to understand its nature, and made a comparison between traditional and Islamic securitization. No study has dealt with the concept of the special purpose

company, whether from a conceptual and advantageous perspective or from jurisprudential perspective in relation to other parties to the securitization process in contemporary Islamic Finance. This dissertation is different from previous studies on the following grounds:

In terms of completeness, this dissertation is more comprehensive and has covered the shortfalls in some of the previous studies, by handling the concept of the special purpose company, its characteristics and nature.

In terms of categorization, this dissertation presented different layout of the research components so as to accommodate the Islamic legal position together with the jurisprudential referencing for the special purpose company, in terms of its relationship with other parties to the securitization process, which is common among countries where this structure is being practiced at present. That would make this dissertation very distinctive from other previous studies.

1. 6 Methodology

This dissertation assumed an inductive research method in data collection. Further, the dissertation assumed the analytical method for investigation, presentation and formulation, all the way through the conclusion about the concept of the special purpose company and its impact on securitization.

1. 7 The Research Plan

This dissertation covered an introduction, five chapters and the conclusion chapter six.

CHAPTER ONE: Introduction: It covered the importance of this dissertation, its objectives, methodology, previous studies and the research plan.

CHAPTER TWO: The Company Literature: The Company in Islamic Jurisprudence and Man-made Law. It falls into two parts:

Part One: The Concept of Company in Islamic Jurisprudence

Section One: The Definition of Company

Section Two: Legality of a Company

Section Three: Categories of Companies: Communal Companies, Property Companies, and Contractual Companies

Part Two: The Concept of Company in the Man-made Law

Section One: The Company by Its General Concept

Section Two: The Company by Its Objective

Section Three: The Company by Its Business and Activities

Section Four: The Company by Its Relationship to Other Companies

CHAPTER THREE: SPECIAL PURPOSE COMPANY (SPC) ROLE IN FINANCE: What is the Special Purpose Company and Its role in finance? It falls into two parts:

Part One: Definition of the Special Purpose Company, Its Development and Reasons behind Its Appearance

Section One: Definition of Special Purpose Company

Section Two: Development of Special Purpose Company

Section Three: Reasons behind the Appearance of Special Purpose Company, and the Need for It

Part Two: Characteristics of Special Purpose Company, and Its Types

Section One: Types of Special Purpose Company

Section Two: Nature of Special Purpose Company and Its Characteristics

Section Three: The Accounting Process for the Special Purpose Company

CHAPTER FOUR: LEGAL AND SHARI'AH FRAMEWORK FOR SPECIAL PURPOSE COMPANY IN ISLAMIC FINANCE: It explains the Securitization Process and the Importance of Special Purpose Company for Securitization in contemporary Islamic Finance. It covers six parts:

Part One: The Concept of Securitization

Part Two: The Pillars of Securitization, Its Importance and Components

Part Three: Types of Securitization and Comparison between the Traditional Model and Islamic Model in Security Issuance

Part Four: Reasons and Prospects of Securitization

Part Five: Legal Dimension (Techniques) and Accounting Dimension of Securitization

Part Six: Importance of Special Purpose Company in Securitization

CHAPTER FIVE: SPECIAL PURPOSE COMPANY (SPC) IN SUKUK STRUCTURING:

The Relationship between the Special Purpose Company and Sukuk Structuring and other pertinent rulings. It falls into two parts:

Part One: The Function of Special Purpose Company in Traditional Securitization, and the Process of Islamic Securitization

Section One: The Function of a Special Purpose Company When Established in the Form of a Company

Section Two: The Function of a Special Purpose Company When Established in the Form of Mutual Fund

Section Three: The Function of a Special Purpose Company When Established in the Form of financing Contract Based on Trust

Part Two: Jurisprudential Documentation of Special Purpose Company

Section One: Relationships Documentation between Parties to Securitization

Section Two: Legal Controls for the Special Purpose Company in Securitization

Section Three: Proposed Model of Special Purpose Company in Securitization Process

CHAPTER SIX: CONCLUSIONS, RECOMMENDATIONS, AND FUTURE OUTLOOK:

This chapter covers the most important conclusions and recommendations.

I would like to point out that any human effort is characterized by flaws and imperfections. Perfection belongs only to the Divine. Anything that is true in

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my writing must have come from the Gracious Lord alone; whatever flaws committed must have come from myself and the devil I ask God Most High to accept this effort as sincere for His own sake. I ask God as well to make out any shortage and fix any flaw. He is the best sponsor and best supporter. May Allah take us by our good faith and intention! He is the source of success, and all praise is due to Him.

[1]Quran. Surat Al-Mulk (67: 14)