

A Rating Perspective of Sukuk Musharakah Transactions

By Juniza Zahari

Introduction

The Malaysian capital market has exhibited tremendous growth in the last 10 years with Islamic securities predominantly premised on the Islamic concept of Bai Bithaman Ajil. The consistent growth in number of Islamic securities issuances; increase in knowledge and expertise amongst market players; progressive development of the Malaysian regulatory framework; and desire to seek a wider investor base into the Middle East market, prompted the promulgation of Islamic issues based on principles of Ijarah, Istisnah, Musharakah and Mudharabah. The year 2004 witnessed a preference of Islamic securities issuances over conventional debt, with Islamic securities forming 49.4% of total private securities issuances (excluding issuances by Cagamas, Malaysia's national mortgage corporation), a significant increase from a mere 7.8% in 1999 (source: *Bank Negara Malaysia*).

Malaysian Rating Corporation (MARC) has rated a number of Islamic securities based on the above-mentioned principles. These include a number of Musharakah-based issues, two of which are securitization issues involving securitization of receivables from the Government of Malaysia and Islamic mortgages. The latest issue that entered the Malaysian market applied the principles of Musharakah Mutanaqisah (based on principles of diminishing partnership). In this article, MARC describes the rating considerations applied to Musharakah-based transactions.

Under the *Guidelines on the Offering of Islamic Securities* issued by Malaysian Securities Commission in July 2004, Musharakah is defined as "a partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing a business venture." Regarded by some as the purest form of Islamic financial instrument, it conforms to the underlying partnership principles of sharing in and benefiting from risks. Profits derived from the venture are shared according to a pre-agreed profit-sharing ratio, but losses according to the respective capital contribution of the parties.

Whilst Musharakah is usually understood to be a non-debt creating mode of financing which typically entails non-fixed returns, this Islamic principle has been successfully applied in fixed income issues. Rating of the transaction involves understanding the underlying structure of the debt instrument, which entails, amongst other things, review of the transacting parties (the parties involved in the partnership) and their capital contributions; the business venture the parties are investing in; the party assuming the role as a wakeel (agent), if any; and the profit or loss-sharing arrangement. Where the Musharakah principle has been used as the underlying structure for a fixed income instrument, MARC's rating considerations are inextricably linked to the rating considerations applied to issues under conventional principles. MARC takes the following factors into consideration.

"Musharakah is a partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing a business venture"

Assessment of the business venture invested in or investments made by the Musharakah partners

The venture will constitute revenue generating ventures which may include investment in contracts, receivables or mortgages. Strength of returns and cashflows from the investments essentially drives the rating of the transaction, the assessment of which falls back on the strength of the counterparty making the payments or the obligor. Consideration is also given to whether the certainty of returns hinges on performance of certain contractual obligations. Where performance risk exists, MARC assesses the ability of the relevant party to fulfil its contractual obligation, taking into consideration the level of complexity of the contractual works.

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Understanding the nature of the partnership arrangement

Musharakah transactions in Malaysia involve partnership arrangements entered into by Musharakah partners comprising Sukuk holders or Sukuk holders and the obligor(s). The issuer of Sukuk Musharakah typically acts as the wakeel (please see further explanation below on the role of the wakeel) for the Sukuk holders, or acts as one of the Musharakah partners. The Musharakah venture may entail cash investments and/or participation in kind (deemed as capital contribution) by the Musharakah partners. Arising from the partnership arrangement, the Musharakah partners will enter into a profit and loss-sharing arrangement whereby profits will be shared according to pre-agreed profit-sharing ratio and losses will be shared according to each Musharakah partner's capital contribution.

For transactions which apply the diminishing partnership concept, i.e. Musharakah Mutanaqisah, the Sukuk holders' interest in the venture will reduce over time with payment of Sukuk to the Sukuk holders (by the obligor/promoter). MARC assesses the risk that the Sukuk holders' interests are compromised as its interest reduces over time. However, agreement by the Musharakah party whose interest increases over time to waive his rights to profit payments until all profits and capital payments are made to Sukuk holders is deemed a necessity so as to ensure Sukuk holders' interests are protected throughout the tenure of the transaction.

Assessment of dissolution events

As Musharakah entails a partnership between the Sukuk holders, assessment of possible events that could result in the

partnership being dissolved is essential. MARC has observed that the events applicable to existing rated transactions are similar to events of default in other conventional issues, for example cessation of business, non-payment of Sukuk, etc.

Understanding the role of the wakeel

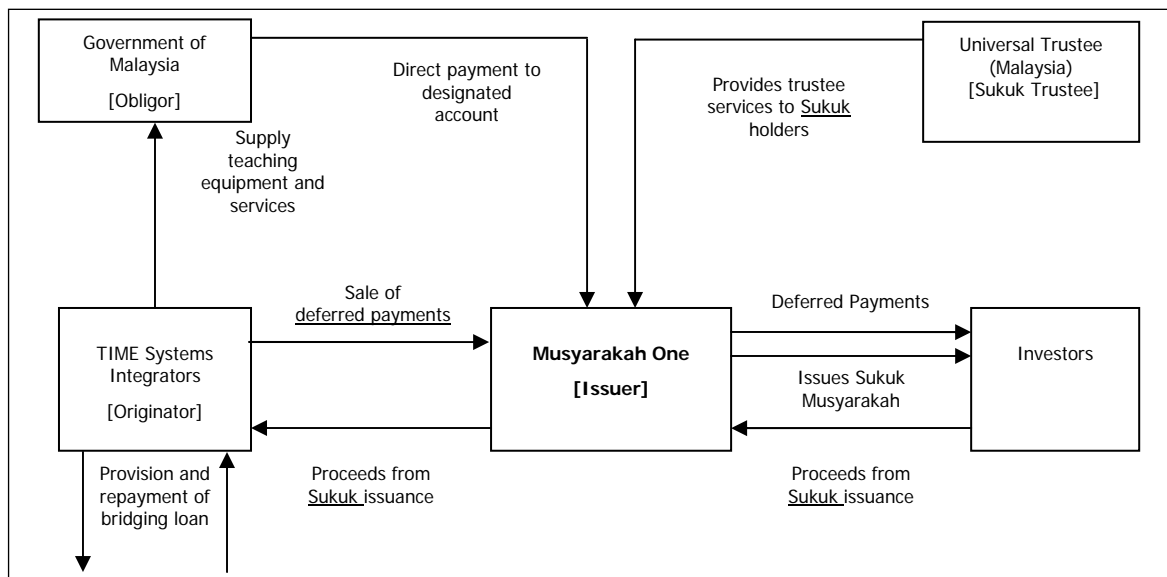
In the contractual arrangements entered into by the parties, an agent (or wakeel) is appointed to act as a trustee on behalf of the Sukuk holders and obligor(s) to enter into the Musharakah venture. In all of the Musharakah issues MARC has rated, the issuers assume the role of the wakeel to act on behalf of the Sukuk holders and the obligor(s). It should be noted that the issuer does not have ownership, represented by rights in, title to, interest and benefit in, the identifiable assets, as opposed to an issuer in an asset-backed securities issue. Instead, a trust relationship is created between the issuer and the Sukuk trustee, the latter acting on behalf of the Sukuk holders and the former acting in trust for the Sukuk trustee and investors (as well as the obligor) to acquire the identifiable assets.

Assessment of ownership in Musharakah venture

With the issuer assuming the role of the wakeel, the Musharakah partners will have beneficial ownership in the identifiable assets. MARC will perform its independent legal review which entails, amongst other things, the enforceability of the security of the Musharakah instrument. Therefore, assessment is made on whether the Musharakah partners have beneficial ownership in the identifiable assets or business venture. In the event of default, recovery efforts will be undertaken by the Musharakah partners, as investors in the business venture.

Transaction structure – a case example

Below is an illustration of the transaction structure of Musharakah One Capital, the first rated asset-backed Musharakah issue.



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Musharakah One is a special purpose vehicle incorporated in Malaysia under the Companies Act 1965 for the purpose of acquiring receivables from TIME Systems Integrators on behalf of Musharakah investors. Musharakah One issued Sukuk Musharakah for the purpose of the said acquisition. Receivables comprise rights in, title to, interests and benefit in the payment obligations of the Government of Malaysia to TIME pursuant to the contract to supply teaching equipment and provision of services to various schools and certain government areas in Malaysia from time to time.

Under the transaction, Musharakah One acts as the wakeel to acquire the receivables from TIME, the purchase of which represents the Sukuk holders' undivided proportionate bene-

ficial ownership in the payments due from the Government of Malaysia. The Musharakah venture is between the Sukuk holders, with sharing of profit and losses based on the Sukuk holders' capital contribution. The rating assigned reflects the credit strength of the obligor, the Government of Malaysia and the elimination of performance risk as receivables are securitized only upon completion of contractual obligation, i.e. upon successful delivery, installation, testing and commissioning of teaching equipment.



The author is an Analyst at Malaysian Rating Corporation, Malaysia.



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Homepage : www.marc.com.my

Bloomberg : MARC

5th Floor, Bangunan Malaysian Re
No 17, Lorong Dungun, Damansara Heights
50490 Kuala Lumpur
Tel : (603) 2092 5398; Fax : (603) 2094 9397

Contacts :

Mohd Asri Awang
Chief Executive Officer
E-mail : asri@marc.com.my

Mohd Izzuddin Yusof
Chief Operating Officer
E-mail : izzuddin@marc.com.my