Securitization In Islamic Framework

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As an idea, securitization is not new. In fact commercial paper, which is very old[1], shares the same basic idea with securitization: transforming debt into publicly held securities[2]. As a new technology, securitization credit is a more efficient, effective technology that offers great benefits to each participant. In the words of one author, *"securitized credit is a new technology for lending that has been developed essentially by non-bankers. It is better on all counts than traditional lending system. it is growing very rapidly precisely because it is a superior technology-one that in fact-is rendering traditional banking obsolete"*[3]. It is because of the securitization is growing very rapidly.

From $ 3 billion in 1970, securitization of mortgages in the U.S.A alone exceeded $ 1.1 trillion in 1993 (Feeney p. 93).

In 1987 structured securitized credit exceeded the total loans made by all commercial banks in the U.S to all business in that country.

At the end of 1992, 55% of mortgages, 3% of automobile loans, 27% of Credit Card receivables and 5% of other consumption loans were securitized in the U.S.A (Tirole p. 163). Securitization is, clearly, one of the most important development in the field of finance in the last two decades.

Until very recently, securitization was an American phenomenon. The first securitized bank loan in France for example was done only in 1988 (Tirole p. 163). The phenomenon is spreading very fast. Conventional banks in many Muslim countries are developing their own progress of structured securitized credit. Islamic bankers must, therefore, be interested in the new technology, and work with Shariah people to develop their own substitute of securitization.

Although our interest in securitization don't come from any need to justify Islamic banking in terms of the modern technical and theoretical banking standards, our needs for securitization comes from two important facts:

a) That securitization is based on the very same idea which made Islamic banking a great innovation, namely making the financial intermediary an agent managing funds not risks. We all know that the conventional

banking model is based on the concept of risk separation. The bank actually separates savers from investors. Hence, savers take the risk of the bank while bank takes the risk of borrowers. Securitization affords savers an opportunity to directly take the risk of the borrowers while making the financial institution an agent earring a fee for arranging deals. It is not difficult to see that this is the concept of Islamic banking where savers actually take the risk of users of funds, in a two tier Mudarabah model. As a mudarib, the bank receives agency fees for arranging deals and portfolio management.

b) The Riba that is prohibited in Christianity and Judaism is exactly the same riba which is prohibited in Islam. The basic tenets of these two religions leads, just like Islam to the prohibition of interest for it fits the definition of riba. The church in the middle ages was even more forceful in its stand Vs usury than Muslims, reaching the point where Christians engaged in usury are not to have Christian burial (see.....). However, their stand against interest was weak, and eventually gave way, became (among other reasons) they failed to come up with any viable alternative to the usurious transactions. Muslims are holding on to the prohibition of Interest because they were fortunate to develop a viable substitute. It

is, therefore, imperative that Muslims keep improving upon this basic model which represent that substitute. Unless we lead a process of financial innovation that tests the limits of permissibility and produces Shariah-acceptable alternative to the new development in conventional banking and finance, we will soon find our model obsolete. This paper surveys, the basic model of structured securitized credit and tries to develop a *Shariah* based substitute that is hopefully just as efficient.

Why Securitize?

Securitized credit is a "more efficient, effective technology that offers great benefits to each participant"[4]. These participants are: providers of funds, users of funds and intermediaries. To all these parties, securitization is superior to conventional finance:

a) Through securitization, originators (particularly banks) will be able to reduce their risk.

(i) through better estimation and control. This is because review and monitoring is done not only originators but also by guarantors and poolers.

(ii) by lowering the concentration of risk because of diversified geographical locations of the debtors to a degree not possible to any single institution, and because of different quality borrowers.

(iii) Since banks no longer have to finance long term assets by short term liabilities and risk capital losses as interest rate fluctuate. They were able to significally reduce interest rate and repayment risk[5].

b) Rather than holding loans on their books. Banks can increase their fee-based income through origination and servicing.

c) Banks can reduce their capital cost (cost of funds of regulatory controls) without reducing their income or ability to meet the needs of their clients. This is because such securitized created is off-balance sheet.

What is Securitization?

In its basic form, securitization is simply the repackaging of asset cash flows into securities. These cash flows can be derived from diverse underlying assets. Securitization of debt and receivable is what is talked about in most cases. This is due to the fact that the majority of assets of financial institutions in the west, where the idea of securitization originated, is of that nature.

If we are talking about a bank, or an installment sale company, securitization would generally mean the repackaging of mortgages, consumer loans or credit card receivables into securities that can be negotiable, or at least transferable in an organized manner. Clearly, the object (in the legal sense) of the transaction are these payable dues. On the other hand if one is talking about for example, a leasing company securitization might be structured in a way that transfers not only the cash flow but also ownership of the leased assets to the holder of the security with all the risks and rewards involved. From the point of view of the theory of contract (both *Shariah* & conventional), there is a difference between securitization of cash flows drawn from real assets and those derived from

purely financial ones. While differentiating between the two is not customary in conventional writing on securitization, doing so affords us a number of insights into the Islamically acceptable ways of securitization. Which is the aim of this paper.

Origins of Securitization

Securitized credit is an outgrowth of U.S. government backed mortgage pass-through program started in the mid 1970's. In that program residential mortgages were pooled together to facilitate guarantee coverage by the U.S. government. These mortgages, which now standard units in the pool covered by the U.S government guarantee, are marketed by securities firms, to end investors. By this, a division of labor in the final market emerged. Rather than one institution originating loans, structuring their terms, carrying credit risks, funding these assets and collecting payments, it is now possible for several institutions to specialize in only one function each.

Structured securitized credit is no longer limited to U.S. mortgage market. Wherever debt is originated, one observes a tendency for structured Securitization, in both developed and developing countries. Very few

bankers will disagree that securitization is one essential ingredient for efficient financial market.

Shariah's Approach to sale of debt:

Certainly the conventional methods of sale of debt are not acceptable from *Shariah* point of view. This, however, does not mean that *Shariah* do not have its own mechanism of desposing of and sale of debt . Debt in *Shariah* represent any "obligation" either monetary or chattel. To sell such debt, there are 2 sets of conditions, one consists of the general *Shariah* rules of contract. The second is exclusively for sale of debt :-

a) The first set of conditions include requirements like being clear of gharar, that the debtor is willfully and knowingly accepts this sale and that creditor has no malicious intent in his sale of the debt ....etc.

b) Monetary debt from Shariah perspective can either be sold for money or for goods i.e. denominating the price in monetary or in commodity terms. If the price of the debt in such contract of sale debt transaction in money, then it cannot be more than nominal value of that debt. This means, that time value of money has to be ignored. If the price of the

debt is made in goods or commodities, then the two parties can agree on any “price”.

c) That the transactions does not include exchange of differed obligations or what is called in *Shariah* the sale of debt for debt. Whether monetary of commodity price, consideration is not allowed to be differed for further payment.

Appreciation of *Shariah* position:

It is important, before we indulge into trying to design the *Shariah* acceptable mode of securitization, to come to grips with the rationale of this position. Clearly *Shariah* permits the exchange and sale of debt. It, however, prohibits that sale in cases where the transaction becomes no more than making money out of money. This is because in Islamic economy there no break-up between real and monetary sector. Money is only a medium of exchange, therefore it is not allowed to become itself a means for generating profit. The Islamic economy has a built-in mechanism to make sure that no independent financial sector is allowed to grow separate from the real sector. *Shariah* closed all avenues that lead to such dichotomy. One positive outcome of such direction is the elimination of business cycles from the

economy because such cycles are the result of the inability to synchronize the activities of the monetary with the real sector.

A proposed model for primary market Securitization:

There is two stages of securitization. Many securitization transactions are limited to the primary market, others are later traded in a secondary market. At this point our proposal present a possible alternative to the former. In the primary market stage of securitization, the originator of debt despose of it for cash to a new holder (investor). In the secondary market stage, these obligations are traded in the open market.

Our emphasis on the primary stage does have a reason. It reflects our concern about the economic agent that is genuinely in need of a means to clear its books of the current receivables. This allows it to continue its original function of trade and industry, and to concentrate on what it knows best. This means leaving debt collection to someone else like banks and financial institutes who are more specialized in such venture. On the other hand, a secondary market for securitized credit only creates speculative tendencies in the economy and introduces a great deal of instability in the

financial sector. This is because the major players in such markets are speculators who make money out of gambling.

Our proposal of credit securitization is based on an already known rules of *Shariah* concerning debt disposition. In other words, this paper contains no new *Shariah* view nor an attempt of ijtihad in the jurisprudence of the subject. Rather it presents a mode operandi based on these established *Shariah* rules for a model of securitization.

Review of the *Shariah* stand on the subject of sale of debt:

Contrary to the opinion of many writers on the subject, *Shariah* does not forbid the sale of monetary debt to a third party.

Debt can be in the form of money or the form of fungible commodity. The first is the standard differed or installment sale transaction, where the buyer is obliged to pay, at a future date a sum of money to the seller. The second is the case of Salam, where the buyer pays the price immediately and the sold commodity is delivered at a specified later date. Both cases a debt obligation is created. In both, *Shariah* provides for means of desposing of such obligation by the creditor.

In the case of Salam, Malikia explicitly allow sale of these commodities by the buyer (creditor) before delivery at any price with only one condition. That is that price is not to be the same as the commodity in which the debt is denominated. A Salam contract that includes the sale of wheat can be sold for money.

In the second case differed payment sale which promises to pay an amount of money at a future date or dates can be sold at any time to third party. However, *Shariah* allows such sale only if price is commodity and not money.

The subject matter of securitization is the second case where the debt is in the form of receivables or monetary obligations to be paid at a future date by a third party.

<u>An illustration:</u>

The following is an example of the case in point. A bought an automobile from B on differed payment basis. The price is to be paid one year from

today. After conclusion of the contract B can dispose of this obligation with a third party. B can buy anything (say furniture) from Mr. C on differed payment basis. Rather than waiting until maturity he can transfer him to B.

The interesting this is that:

a) C need not be a producer or a trader in furniture. Rather he can buy such from the market for the sole purpose of delivery to B.

b) B and C can negotiate the rate of discount of the debt obligation of A. Suppose that debt is equal to $ 1000 payable Jan 1 of next year. B is willing to, conventionally, discount it today for $ 970.

He can do the same thing here except that B will pay him $970 worth of furniture not money.

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[1] In his Economic structure of the ancient Near East (London, Croom Helm, 1983) Moris Silver believes there is evidence that negligible debt certificates where known since 1800 BC (P. 60).

[2] Donald Chew, edit, New Banking Development, London Blackwell finance (P. 53).
[3] Lowell Bryen: Breaking up the bank: Rethinking an industry under siege. Homeword, Ill Dow Jones Irwin 1988 (P. 63)
[4]Journal of Applied corp finance (P. 72)
[5](Rosenthal & Ocalupa (P.5)