

28. SECURITIZATION

Securitization means issuing certificates of ownership against an investment pool or business enterprise. This chapter discusses the issues, problems and rules in issuing such certificates with respect to the “nature” of investment pool. Basic guidelines are also provided on the negotiability and sale of these certificates in the secondary markets.

Securitization of Musharakah

Musharakah is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a Musharakah certificate, which represents his proportionate ownership in the assets of the Musharakah, and after the project is started by acquiring substantial non-liquid assets, these Musharakah certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the Musharakah are still in liquid form (i.e. in the form of cash or receivables or advances due from others).

For a proper understanding of this point, it must be noted that subscribing to a Musharakah is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest. The Musharakah certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. 1 million each, have been issued. It means that the total worth of the project is Rs. 100 million. If nothing has been purchased by this money, every certificate will represent Rs. 1 million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate is sold for more than Rs. 1 million, it will mean that Rs. 1 million are being sold in exchange for more than Rs. 1 million, which is not allowed in the Shariah, because where money is exchanged for money, both must be equal. Any excess on either side is Riba.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the Musharakah certificates will represent the holders' proportionate ownership in these assets. Thus, in the above example, one certificate will stand for one hundredth share in these assets. In this case it will be allowed by the Shariah to sell these certificates in the secondary market for any price agreed upon between the parties which may be more than the face value of the certificate. Since the subject matter of the sale is a share in the tangible assets and not in money alone, therefore the certificate may be taken as any other commodity which can be sold for a profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or

raw material, while the rest of the money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due on its customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of the Shariah in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the Musharakah certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi'i school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and sold independently.

The Hanafi school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

Suppose, the Musharakah project contains 40% non-liquid assets i.e. machinery, fixtures etc. and 60% liquid assets, i.e. cash and receivables. Now, each Musharakah certificate having the face value of Rs. 100 represents Rs. 60 worth of liquid assets, and Rs.40 worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60. If it is sold at Rs. 110 it will mean that Rs. 60 of the price is against Rs. 60 contained in the certificate and Rs. 50 is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60 or less, because in the case of Rs. 60 it will not set off the amount of Rs. 60, let alone the other assets.

According to the Hanafi view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the non-liquid assets represent less than 50% in the whole, its trading according to the above formula is allowed.

However, most of the contemporary scholars, including those of Shafi'i school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%.

Therefore, for a valid trading of the Musharakah certificates acceptable to all schools, it is necessary that the portfolio of Musharakah consists of non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50% but the size of the non-liquid assets should not be negligible.

Securitization of Murabaha

Murabaha is a transaction, which cannot be securitized for creating a negotiable instrument to be sold and purchased in the secondary market. The reason is obvious. If the purchaser/client in a Murabaha transaction signs a paper to evidence his indebtedness towards the seller/financier, the paper will represent a monetary debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore,

the paper representing a monetary obligation arising out of a Murabaha transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like Musharakah, leasing and Murabaha, then this portfolio may issue negotiable certificates subject to certain conditions.

Securitization of Ijarah

The arrangement of Ijarah has a good potential of securitization, which may help create a secondary market for the financiers on the basis of Ijarah. Since the lessor in an Ijarah owns the leased asset, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.

Therefore, if the lessor, after entering into Ijarah, wishes to recover his cost of purchase of the asset with a profit thereon, he can sell the leased asset wholly or partly either to one party or to a number of individuals. In the latter case, the purchase of a proportion of the asset by each individual may be evidenced by a certificate, which may be called an Ijarah certificate. This certificate will represent the holder's proportionate ownership in the leased asset and he will assume the rights and obligations of the owner/lessor to that extent. Since the asset is already leased to the lessee, the lease will continue with the new owners, each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly, he will also assume the obligations of the lessor to the extent of his ownership and in case of the total destruction of the asset, he will suffer loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by Islamic banks and financial institutions.

It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue Ijarah certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset. It means that the holder of such a certificate has no relation with the leased asset at all. His only right is to share the rentals received from the lessee. This type of securitization is not allowed in the Shariah. As explained earlier in this chapter, the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in the Shariah, because trading in such an instrument amounts to trade in money or in a monetary obligation which is not allowed, except on the basis of equality. If the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated, therefore, this type of Ijarah certificate cannot serve the purpose of creating a secondary market.

It is, therefore, necessary that the Ijarah certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.