

## Defaults and the maturing Sukuk market

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While the Sukuk market has come a long way since its humble beginnings, there are always observers who will make the case that it could have come on even further. Indeed this is true and the Islamic debt capital market has undoubtedly been held back by some problems that will need to be addressed before the industry can make the top speed that it is capable of. Some of these issues are legal and some are regulatory and some come down to the basic question of how to market Sukuk best.



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## Defaults and the maturing Sukuk market

It has been written that the United States Securities Act of 1933 “did not spring full grown from the brow of any New Deal Zeus”. Rather, the act was the culmination of centuries of legislation in multiple jurisdictions. While we do not intend to imply that the maturation of a market for an economic instrument is analogous to the evolution of a regulatory system or that the solution to the recent downturn in the market should be the product legislation, the concept of a system growing over time aptly describes the current state of the Sukuk market. Until recently the growth of the Sukuk market has been driven more by an abundance of financial resources than by legal considerations. The current competition for scarce funds across the globe may highlight the importance of the legal considerations underlying financial products, both Islamic and conventional. How Sukuk structures fare in the face of defaults should clarify what they are in a legal sense. This clarity, in turn, may light the path of the maturation process of the Sukuk market.

In conventional finance and investment markets, the post-default path is well worn. For this reason, much of the process of structuring and documenting transactions, particularly in common law jurisdictions, accounts for the possibility of a worst case scenario. Precedents indicating what such a scenario may entail are readily available in the context of conventional transactions. The same cannot be said for Islamic transactions.

Another factor contributing to the uncertainty surrounding post-default Sukuk is that many are subject to partially or wholly non-Shariah based legal regimes. For example, the legal documents governing Sukuk or the Islamic structures underlying Sukuk are often subject to English law. Moreover, legal documents comprising separate components of the same Sukuk issuance may be subject to different legal regimes. How Shariah based transactions structures will be characterised and treated in various applicable jurisdictions cannot be known with any high degree of certainty prior to the resolution of disputes and enforcement of rights in the relevant jurisdictions.

Certainty with regard to the post-default process in Sukuk transactions is necessary because the potential for a default exists in all types of transactions. Even the most prudently structured products can fail due to circumstances outside investors’ control. Consequently, risk is inherent in any transaction, whether Islamic or conventional although an argument can be made that an Islamic investor should be better prepared to assume a higher degree of risk than a conventional investor. This is not to imply that Islamic products are by definition riskier than conventional ones, but within the parameters (ethical and financial) of what Shariah considers to be a compliant investment product, Islamic investors should be prepared to assume the risks inherent in making an investment in such product.

Clarity as to what may reasonably be expected in a default scenario with respect to any financial transaction leads to an enhanced ability to foresee and mitigate the risks inherent to that type of transaction. Until a right is interpreted and enforced, the benefits enjoyed by the person holding that right are limited to the benefits resulting from the obligations that the corresponding obligor is willing or able to perform. In a sense, defaults in a type of transaction reveal the actual rights held by investors in that type of transaction.

Knowledge of such rights allows the financial practitioners structuring and documenting that type of transaction greater ability to mitigate the risks inherent to that type of transaction. The foregoing applies to a great extent to the Sukuk market. In fact, the knowledge factor is compounded in the context of Sukuk products as the assets on which such products are based (or by which they are backed) are scattered in multiple jurisdictions which apply different legal systems (Islamic, common law, civil law or hybrid legal systems) and which may vary in terms of the maturity of their judicial systems and enforcement mechanisms. This gives rise to the need for a comparative study of how each default is being handled in the relevant jurisdictions. Such study will be far from complete absent meaningful cumulative feedback on the manner by which Sukuk default scenarios were treated.

The defaults facing various Sukuk in the current market are therefore not entirely negative occurrences. Nor can it be said that those defaults alone represent a maturation of the Sukuk market. Instead, each default represents another incremental opportunity for increased knowledge about the relevant Sukuk and its underlying structures. That increased knowledge will better equip those structuring and documenting Sukuk transactions to understand and address the risks facing those Sukuk transactions. Ultimately, current defaults in Sukuk, though unfortunate in a number of respects, are likely to prove catalysts for the maturation of the Sukuk market rather indications of the achievement of maturity.

Another significant area that needs to be addressed is that of Shariah compliance and whether or not Shariah convergence is something to be aspired to. The reality is that different scholars have different opinions about different products. But perhaps of greatest concern is the tendency of some scholars to have different views on the same subject at different times.

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## Zawya Collaborative Sukuk Report

The above thought leadership piece is part of the Zawya Collaborative Sukuk Report, an agenda setting study for the growth and development of the global Sukuk industry, and can be found in the “Core Weaknesses of the Sukuk Market” section. A full version of the report is available on [www.zawya.com/sukuk/report/](http://www.zawya.com/sukuk/report/)

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It’s flagship service, Zawya Investor, provides paid members access to insights that are “from the region, to the region” to help them identify the best investment opportunities in the Middle East. With high profile Zawya Dow Jones journalists breaking the most important stories and Zawya’s own team of financial experts providing in-depth analysis, Zawya Investor offers unique coverage of the region’s IPO, Public & Private Equity, Funds, and Global Sukuk industries.

In the Islamic space, Zawya has a dedicated a team of three analysts that focus on highlighting opportunities in the global Islamic Finance sector, with particular emphasis on Sukuk, by bridging the buy side, sell side and all relevant players in the industry. All members can register to the Zawya Network, an online network enabling them to forge valuable relationships with fellow professionals, and share in the knowledge and experience of the business and investment community focusing on the Middle East. In the Zawya Network, over 500 members are part of the Islamic Finance and Sukuk groups.