

Asset-backed Securities as Attractive Financing and Investment: The Malaysian Experience

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The main objectives of the study are to overview on the mechanics of Sukuk Asset-Backed Securities (ABS) as a form of corporate debt financing and measure the ability of the originators to reduce their debt obligations and enhance their earning capacities in the Malaysian capital market. All Sukuk ABS issues are covered in its introductory year of 2005 in which their performances are measured based on the selected financial ratios for one year before, during the year and one year after their issuances of ABS. Generally, the results of study meet the underlying purpose of ABS issues with all three originators show satisfactory reductions of their debt obligations and enhancements of their book value per share. The study concludes that the successful testimony of Malaysian Sukuk ABS based on the syariah (Islamic) principles could become an attractive debt financing for companies and form of investment for investors.

Field of Research: Finance, Asset-backed Securities (ABS), Developing countries

1. Introduction

Securitisation conceptually involves packaging financial promises and transforming their cash flows into a form whereby they can be freely traded among investors. The market for asset backed securitisation (ABS) that includes home equity loans, credit cards, automobile loans and equipment leases, increased from \$316 billion in 1996 to US\$1.103 trillion in 2005, a fantastic record of a trillion dollar mark transactions over a 10-year period. Asset-backed securities constitute a growing segment of the US, European and global capital markets. In recent years, the ABS market has enabled companies and banks to finance a wide range of assets in the public debt market and has attracted a variety of fixed-income investors.

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The asset securitization techniques even though it complex, has won a secured place in corporate financing and investment portfolios because it can, paradoxically, offer originators a cheaper source of funding and investors a superior return (Giddy, 2000). In finance literature, Asset-Backed Securitisation (ABS) is defined as a creative way of raising funds through the issuance of marketable securities backed by future cash flows from revenue-producing assets. As such, securitisation is the transformation of an illiquid asset into a security that is issued and more importantly it can be traded in a capital market. The term asset-backed security (ABS) is generally applied to issues backed by non-mortgage assets (Siew, 2004). These asset securitisation techniques are being embraced by a number of Asian countries seeking to promote home ownership, to finance infrastructure growth, and to develop their domestic markets, including Malaysia (Keng and Ting, 2004).

In Malaysia, since ABS was first introduced to the domestic market in 2001, much has been said about the potential for securitisation in Malaysia and the fresh impetus it brings to the capital market. Though three ABS deals followed quickly on the heels of the regulatory guidelines in 2001, the market has since little activity of a similar nature. This scenario is obvious as the past year of 2002 only saw two securitisation transactions coming into the market whilst another two deals that had long been in the pipeline eventually failed to make a debut for various reasons. With transactions worth RM 2.37 billion in 2003, ABS only forms a miniscule fraction of the fast growing above RM100 billion-debt market in Malaysia. In general, the total value of asset-backed securitization (ABS) in Malaysian market is growing rapidly from year to year. Starting year 2001 where the first of ABS is being issued, the spread between year 2005 and year 2001 is too large. According to a local rating agency, Rating Agency of Malaysia, since 2005, asset-backed securitization (ABS) is gaining acceptance and is adding new depth to the local debt market. This scenario is obvious as in 2005, it has increased superbly by 142.93% amounting to RM9.327 billion from RM3.839 billion in 2004. By looking at the positive trends, the ABS issuances are expected to increase in impetus given the attractiveness of this structure as a source of financing, notably Islamic ABS on sukuk financing. By procedure, originators refer to the owners of assets that have been securitised with the appointment of Special Purpose Vehicle as issuers of ABS.

2. Objectives of the Study

Based on this premise, the initial objectives of the study are to overview the Malaysian ABS market, examine the mechanics of Islamic securitisation and explore the potential use of Syariah ABS as an alternative debt financing in Malaysian capital markets. The ultimate objective of the study is to verify that Syariah ABS issues have an ability to increase the value of the originators.

3. Research Scope and Methodology

The study will examine the mechanism of Sukuk ABS as opposed to conventional ABS in Malaysian capital market to conform the position of Kuala Lumpur as global *halal* financial center. Since Sukuk ABS is relatively new in Malaysian debt market and non-existence in other Muslim countries, the study is timely as it has huge potential due to its global acceptance. However, as a preliminary study, no statistical tools and methodological issues will be addressed. Nevertheless, the study explores its framework for better understanding on its potential use as form of financing to companies and strategic tool for expansion programmes in obtaining cheaper debt financing and enhancing the value of the firm.

As a preliminary study, the data will be collected from the annual reports of the Malaysian Sukuk ABS originators only for year of 2005. Year of 2005 is chosen as it marks the launching of Malaysian Sukuk ABS. However, year of 2006 is not covered as the study could not have the financial statements for financial year of 2007. This is justifiable, as the financial performance of original owners of the securitised asset will be evaluated preliminarily for one year before, during the year and one year after the issuance of their respective ABS. As such, the data will be analyzed using the selected financial ratios of the originators to measure their ability to reduce the debts obligations, enhance their earning capacities and improve their book value.

4. Overview of Islamic Asset-backed Securities (ABS)

The regulated Malaysian ABS is timely as securitisation is already providing to an important option for governments seeking to promote private-sector growth and employment and to access funding for infrastructure development, as contained in the Ninth Malaysian Plan. Interestingly, Malaysia was the first country in the region, probably one of the earliest among the developing countries to establish a secondary mortgage market, in which it is one of the categories in asset backed securities. As such, we are motivated to verify that the use of Malaysian Sukuk ABS can represent an effective form of cheaper long-term financing for Malaysian companies. Invariably, the underlying asset in an Islamic asset-backed transaction cannot contain any elements that contradict Syariah. However, the mere pooling of non-interest bearing assets alone does not automatically create an Islamic securitization scheme. The fact is that each facet of the Islamic securitization program needs to be Syariah compliant (Engku Ali, 2006). For instance, apart from elimination of the interest factor, the underlying asset would also need to fully satisfy other conditions. These tests include presence of the asset or certainty over its deliverability, performance or availability at a future date; that the asset is beneficial to the Muslim ummah; that the asset is “halal” (lawful) according to Syariah; that the asset can be delivered free from encumbrances; that the underlying subject matter can be adequately identified, specified or characterized without any ambiguity and that the seller has ownership over the asset.

The lease-based securitization starts with the identification of a suitable underlying asset. To be suitable, the asset must be capable of both sale and leasing. In terms of the contractual flow, the process normally starts with the originator selling the identified asset to the Special Purpose Vehicle (SPV). The SPV will then enter into a lease contract with the originator. The lease contract creates a stream of income in the form of rental payments in favor of the SPV. The SPV then issues the sukuk that are supposed to represent an undivided proportionate ownership over the leased asset. From the Islamic legal perspective, the buyers of the sukuk effectively bought a portion of the leased asset, and thus, become co-owners of the asset. As owners, the sukuk-holders are also the lessors to the originator, and are therefore entitled to the stream of rental payments. Finally, at the end of the lease period (reflecting the maturity of the sukuk), the originator will redeem the sukuk from the holders, effectively buying back the underlying asset from them. Based on the above explanations on the sukuk al-ijarah structure, a number of Islamic legal observations can be made. First, the sukuk does not represent debt but represents undivided proportionate ownership of the leased asset. In this sense the sukuk are not debt instruments, but more of participatory certificates (similar to equities). Second, because the sukuk are not debts nor monetary, the Islamic legal difficulties in the sale of monetary-debts with a discount do not arise. Third, sukuk represent the leased property (normally real assets), and thus, can be bought and sold at whatever prices that the parties agree to. All these factors explain the worldwide endorsement of sukuk al-ijarah as syariah compliant securities.

5. Profile of Islamic ABS in Malaysia

All Islamic ABS issues in Malaysia must comply with Securities Commission (SC) guidelines issued pursuant to section 32 of SCA 1993, as and when they are applicable:

- i) Guidelines on the Offering of Asset-backed Securities
- ii) Guidelines on the Offering of Private Debt Securities
- iii) Guidelines on the Offering of Islamic Securities

As such, SC defines ABS as “private debt securities that are issued pursuant to a securitization transaction. Such private debt securities shall exclude all debt securities that are capable of being converted into equity howsoever and whether redeemable or otherwise. Examples of such excluded debt securities include exchangeable bonds and private debt securities with attached warrants”. In addition, SC defined securitization transaction as “an arrangement, which involved the transfer of assets or risk to a third party where such transfer is funded by the issuance of debt securities or Islamic securities to investors. Payments to investors in respect of such debt securities or Islamic securities are principally derived, directly or indirectly, from the cash flows of the assets”.

Under the Guidelines, the definition of “Assets” relates principally to cash flow stream, normally in the form of:

- i) Credit card or hire-purchase receivables
- ii) Trade receivables such as collection of toll charges, say by an independent toll-road operator;
- iii) Bond or loan obligations.

For Islamic ABS, the cash flow stream must be syariah compliant, that is no interest income. In view of global acceptance of the Malaysian Sukuk ABS (Engku Ali, 2006), the study examines its potential use as corporate financing for its introductory year of 2005 as illustrated by the following table:

Table 1: List of Malaysian Sukuk ABS as At 31 December 2005

No	Originator	Issuer	Instrument	Issue Size (Rm Million)	Adviser
1	Time Systems Intergrators Sdn Bhd	Musyaraka h One Capital Berhad	Asset-Backed Sukuk Musyarakah Issuance Programme	2500 (14 years)	CIMB Berhad
2	Government Of Malaysia ("GOM")	Cagamas MBS Berhad	Asset-Backed Sukuk Musyarakah Issuance Programme	2050 (15 years)	CIMB Berhad, HSBC Bank Malaysia Berhad
3	Boustead Holdings Berhad ("Boustead")	Golden Crop Returns Berhad	Sukuk Al-Ijarah	442 (8.5 years)	Affin Bank Berhad

6. Results and Discussions

As a syariah instrument, any profit shall be shared between the Sukukholders in proportion to their capital invested and the expected profit rate of each Tranche. Pursuant to a Tanazul (waiver) arrangement, the Sukukholders will amongst themselves agree that they shall waive any profit in excess of the expected profit rate for each Tranche. Profit will be calculated on the basis of actual number of day's elapsed and actual number of days in the year. Any loss shall be shared between the Sukukholders in proportion to their capital invested in the Musyarakah. The proportions for the sharing of loss are computed as the ratio of capital invested by each Sukukholder (as represented by the nominal value of the Sukuk held) to the

total capital invested by all Sukukholders (as represented by the nominal value of all Sukuk).

Therefore, as a preliminary study, the financial performance of originators are evaluated by selected financial ratios on the basis of one year before, during the year and one year after issuance of their respective Sukuk ABS as follows:

Table 2: List of Malaysian Sukuk ABS as At 31 December 2005

Period	Boustead Holdings Berhad (Boustead)			Time Systems Intergrators Sdn Bhd (Time)			Government Of Malaysia (Cagamas)		
	<i>Before</i>	<i>During</i>	<i>After</i>	<i>Before</i>	<i>During</i>	<i>After</i>	<i>Before</i>	<i>During</i>	<i>After</i>
ROA (%)	2.60	4.09	5.68	0.74	0.95	1.24	0.67	1.02	0.82
ROE (%)	6.60	11.20	11.67	11.70	43.80	42.44	15.1	19.87	16.5
DTA (%)	48.20	53.90	46.46	48.30	7.51	8.50	95.60	94.80	94.90
TIE	2.82X	2.41X	2.95X	1.63X	2.01X	2.68X	1.29X	1.56X	1.50X
EPS (RM)	0.21	0.32	0.26	1.35	0.88	0.81	1.34	2.19	0.94
BVPS (RM)	3.19	3.11	3.36	1.15	2.03	2.41	8.84	11.03	11.81

As a preliminary study, the authors believe it is sufficient to determine the ability of the originators in obtaining a cheaper debt financing on the basis of the above selected financial ratios. Firstly, for the returns on investment in assets (ROA) and equity (ROE), the results conform to the enhancement of returns. Out of 3 originators, all companies (100%) managed to show better performance from one year before to one year after issuance of Sukuk ABS. Secondly, for the debt obligations, all 3 (100%) originators showed satisfactory improvements with slight reductions in debt capital structure and significant interest payment coverage from one year before to one year after sukuk ABS issuances. As such, this preliminary study seems to meet the fundamental objective of the originators of ABS in obtaining cheaper debt financing.

Finally, for earning capacities, generally the results meet the main purpose of ABS issues in determining the ability of the originators to enhance their profits and value of their firms. Interestingly, for book value per share (BVPS), all 3 (100%) originators improved their equity capital satisfactorily one year before to one year after issuances of their respective sukuk ABS. However, only 1 originator (33%) managed to raise their earnings per share (EPS) for one year before to one year after ABS issuances, while another 2 (67%) could not raise their EPS significantly. Nonetheless, all 3 originators of Sukuk ABS generally have met their objective in reducing their debt obligations and raising their earning capacities.

7. Concluding Remarks and Key Challenges

Generally, the author believes that Malaysian ABS is poised to perform superbly by 2010 and sets to dominate the private debt securities, notably the substantial issues of Sukuk ABS. Therefore, ABS issues will not only become a prominent corporate debt financing for public companies but also appeal Malaysian investors as a profitable form of investment. Despite of slow take off in 2001 and 2002, the Malaysian ABS market has been trying to call for strong investors' appetite for highly rated papers and growing confidence in heavily structured instruments. With the success stories of ABS issues in US, Europe and Australia as a cheaper debt financing for companies and better investment returns for investors, Malaysian ABS starts to improve its position significantly in 2005 in terms of number and size of issues. In fact, the presence of ABS in Malaysian capital market is felt further with the introduction of Sukuk ABS in the same year.

As expected globally, the Malaysian Global Sukuk received worldwide syariah compliance endorsement, and the sukuks are accepted in major markets in Bahrain, the Middle East and Europe. The successful story of sukuk al-ijarah owes largely to the worldwide syariah compliance endorsement of the issues and the transactions involved. The endorsement ensures acceptability of the sukuk by the international markets. In view of this, as a creative debt financing that acts as risk management tool, Sukuk ABS can appeal investors from the Middle-East countries. In fact, according to IIFF Europe that was held in Geneva in November 2006, it was estimated that Arab investors have more than US\$ 800 billion on deposit in overseas banks, much of which is secured in Swiss banks. Likewise, calls for Arab investors to repatriate their wealth in the wake of 9/11, sluggish western stock markets and attractive Middle-East property investment opportunities, have seen many hundreds of millions of dollars return to the Middle East. Therefore, the success launchings of Malaysian Sukuk ABS in 2005 for its global Syariah acceptance will become a strong testimony for big Malaysian companies to issue it as creative and cheaper debt financing in the near future.

More importantly, one striking trend has been the growing demand for Syariah compliant banking and with so much at stake, European banking and finance professionals are starting to sit up and take notice. Therefore, we are motivated to validate preliminarily that the Sukuk ABS can become a significant debt financing globally with the presence of an asset, the asset must generate cash flow and no recourse to originator, which in turn helps the originator to remain competitive and maximize its value. On more basic level, the Malaysian debt market appears paying the price of the 1997 crises. The reluctance of investors to accept debt papers rated lower than single "A" has been a reason often cited for the sluggish growth of the corporate bond market. Likewise, a number of structured and securitization deals have been stalled. With the market at still infancy stage, investors are still getting acquainted with the intrinsic differences between ABS and corporate bonds. Though take up has been slower compared to corporate debt securities, all ABS have been well received with subscription rates almost two times or more. In fact, according to

merchant banks as lead managers and RAM as a rating agency, investors are willing to hold until maturity because Malaysian ABS issues seem to offer regular superior returns and secured principal repayment as compared to other long-term fixed income securities, notably Sukuk ABS.

As marketable and highly rated securities, like the ordinary shares, Malaysian ABS should follow the process of Initial Public Offering (IPO) to give better guidance to the prospective investors, notably on the financial track-record of the originators and issuers. With the number and size of issues are on the rise since 2005, notably syariah ABS and synthetic assets, Malaysian Sukuk ABS is in a position to lead the development and growth of private debt market. As such, by 2010, Malaysian ABS will become the premier cheap debt financing for the Malaysian companies and profitable form of investment for the Malaysian institutional and individual investors.

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