Meeting demand: The case for structured finance in Oman

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John Sproat of ***Al Busaidy Mansoor Jamal & Co*** in Muscat looks at the opportunities for structured finance in Oman

Introduction

Structured finance is an important financial tool for both lenders and borrowers, whose financing needs are complex and cannot easily be satisfied by an ordinary loan or other debt security. The concept of structured finance has evolved over the years, from financing which involved structures that sought to take advantage of accounting and tax arbitrage opportunities to more sophisticated forms of structured finance, involving various forms of securitisation, collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and, even more recently, covered bonds. As well as providing an alternative and often cheaper cost of funds, a common ingredient in most structured finance transactions is also the transfer of some of the risks previously associated with owning or holding the underlying assets.

The principal markets for structured finance are in North America and Europe. More recently, however, structured finance products have begun to emerge in the Middle East, particularly in the more sophisticated financial markets such as Dubai, Abu Dhabi and Qatar.

In Oman, few structured finance transactions have taken place to date, although a number of the prerequisites for structured finance transactions are starting to emerge. As the demand for capital increases, particularly for residential homeownership and the expanding business sector, and as the supply of capital becomes more limited due to declining oil revenues and the government's own borrowing requirements, alternative forms of finance such as structured finance may provide an alternative source of capital.

At present, Oman's legal and regulatory system does not facilitate the development of structured finance products. However, the country's rapidly developing Islamic finance sector offers some prospect of *shariah*-compliant structured finance products being developed in a manner similar to conventional products that have developed elsewhere over the years.

Leasing

The international financial reporting standards (IFRS) are generally applicable in Oman. The application of those accounting standards to corporate and other business entities creates structured financing opportunities and solutions.

In most cases, the lease of assets which would otherwise be purchased with borrowed money is a form of structured financing of those assets. Although lease financing is often driven by a desire to achieve accounting and funding outcomes, it is also used to transfer some of the risks of ownership of assets (including redundancy risk at the end of the asset's useful life). Leasing often provides a business with an easier way of disposing of an asset at the end of its useful life or when it becomes surplus to their current needs.

In Islamic financing, a lease (or a sale and leaseback) structure (an *ijarah*) is often used as a means to monetise an asset and raise capital, which is then serviced out of the rental payable under the lease/*ijarah*. In Oman, this structure has been used to fund the development of the Muscat Grand Mall and was also an integral part of the $650 million *sukuk* (Islamic bond) issued by the Government of Oman in November 2015.

Structured financing using a lease or *ijarah* structure is a proven method of raising capital for parties who own land, buildings or other assets which are transferable and which can be realised when the capital is required to be repaid.

Securitisation

The concept of securitisation as a means of raising finance from the monetisation of existing assets is reasonably well understood. While some financial commentators view securitisation as the cause of the global financial crisis in 2008-2010, over the past 30 years it has proved an important financial tool enabling banks and other lenders to provide cost effective credit to home owners and SMEs, which they would not otherwise have been able to obtain.

In Oman, there is a growing demand for SME finance and for mortgage finance to purchase residential homes. A form of mortgage-backed or other asset-backed securitisation would enable banks and other lenders to meet the growing demand for credit potentially at a lesser cost. However, Oman's current law and regulations do not allow conventional securitisation structures to evolve. For example, banks are unable to establish subsidiaries and there are limits on the ability of banks and other lenders to transfer assets to special purpose vehicles. Furthermore, when the assets are transferred to a separate entity and 'securitised' there are restrictions on the ability to enforce security over those assets and recover the amounts secured.

Interestingly, Islamic financing structures are not constrained in the same way as conventional securitisation structures. In fact, amendments made to Oman's banking and capital markets laws to encourage Islamic financing, could enable banks and other lenders to securities existing assets to raise capital to meet demands in other parts of their businesses. The capital raised from the Islamic financing could be used to free up other capital in the bank, for use in its conventional business provided that business was shariah compliant.

CDOs and others

As noted above, as structured financing and securitisation has become increasingly sophisticated in the US and Europe, other products such as collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs) have been developed to meet investor demand. However, it is likely to be some time before those products emerge in Oman.

Covered bonds

The more recent development in structured financing is the emergence of covered bonds. Although the concept of covered bonds (*Pfandbriefe*) has been in Europe for over 200 years, it was only as a result of the global financial crisis that American, Australasian and UK banks discovered their benefits.

Essentially, a covered bond is a normal bond or debt security which is issued by a borrower (often a bank), but the borrower’s obligations are secured over specific blue chip assets of the borrower which have been set aside from the borrower’s normal creditors. Often, the setting aside of the assets involves their transfer to a separate bankruptcy-remote vehicle. This guarantees the borrower’s obligations under the covered bonds and grants security over the assets to secure its obligations under the guarantee.

Given the increasing liquidity constraints suffered by Omani banks, covered bonds may be an alternative means of accessing capital which would not otherwise be available to those banks particularly, given their diminishing international credit ratings. Given the recent changes to the legal system to encourage Islamic financing, it may be possible to look at a *shariah* compliant solution to facilitate the issue of covered bonds by Omani banks.

An Islamic covered *sukuk*?

In Oman, it should be possible, under current law, for a bank to issue a covered *sukuk*. The bank could transfer *shariah*-compliant assets to a special purpose company (SPC), which may be a subsidiary or an unrelated company, and issue a *sukuk*. The payments on the *sukuk* issued by the bank would be guaranteed by the SPC and secured over the *shariah*-compliant assets acquired by the SPC. The issue of covered *sukuk* by the bank could open up a new source of investors and also result in a cheaper cost of capital.

Conclusion

As noted at the outset of this paper, structured finance is a valuable financial tool for both lenders and borrowers alike, in broadening the sources, and reducing the cost of capital. Similarly, it provides an important means of spreading and diversifying financial risk in any developed financial system. While Islamic financing structures will play an ever-increasing role financing Oman’s economic development, they are only one tool in the tool box of available financing structures. Conventional structured finance and, in particular, asset securitisation, offers significant potential for financing Oman’s economic diversification strategy that aims to reduce the county’s reliance on hydrocarbons revenues and stimulate growth in non-oil sectors. This would require amendment to existing banking and finance laws and regulations.

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