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**Overcoming barriers to liquidity; Commoditization,
Sukuk, promoting issuance and a secondary market**

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Overcoming barriers to liquidity; Securitization, Sukuk, Promoting issuance and a Secondary Market

Thank you very much for inviting me to discuss some very important topics in the evolution of Islamic financial markets. I will begin my presentation by shedding some light on the differences between the debt markets of developed and emerging economies, and the need to have an active secondary market for debt. The fact that the secondary debt market in developed economies is at an advanced stage, makes it a benchmark for Islamic Financial Markets. A comparison of the characteristics of the conventional secondary debt market, against characteristics of Islamic financial market, highlights the gap between the target to be achieved, and the stage at which the market currently stands. This will be followed by a brief account of barriers constraining development of efficient and liquid debt markets in Islamic Finance, along with a discussion on whether the complexity in the structure of the instruments is an impediment to liquidity or not.

Trading rationales and the incentives for trading will also be discussed, and I will conclude my discussion by highlighting the role that a credit rating agency can play, in the development of a profound set of debt market expectations that can form the foundation of informed investor's decisions and ultimately increase trading volumes, liquidity and market depth.

As you know, the debt markets consist of government and agency bonds, corporate bonds, municipal bonds, asset backed securities, and Islamic financial instruments. Participants in secondary debt markets include institutional investors, governments, traders and individuals. Whereas, the dominant players in the issuer's market are Sovereign and Sub Sovereign bodies, the secondary market is usually dominated by banks and financial institutions.

Developed economies have efficient public debt markets where most primary offerings are sold. As indicated by its rating, an issuer's financial strength, and external support, define the credit strength, and determine the pricing of an issue. The nature of sovereign debt means it is less risky than other forms. As a result, it normally sells at less attractive yields compared to non-sovereign debt.

In emerging capital markets, as in developed markets, the dominant role is normally played by the Sovereign. The corporate debt instruments are also emerging on the scene.

Secondary Markets

Once issued, debt securities are traded in the secondary market. This process contributes to efficient pricing for upcoming issues. Unlike the stock markets, or futures and options markets, secondary trading in debt securities, in most countries, remains decentralized, although some securities regulators have sought to promote trading by requiring that the debt be listed on stock exchanges.

Liquidity of an issue is predicated on the breadth and depth of the buying base. It is measured with the help of the difference between bid and ask prices (generally called bid-ask spread) and is determined by the trading volume. For sovereigns or sub-sovereigns high volumes lead to efficient pricing and lower bid-ask spread, while debt issued by lesser known borrowers suffers from lack of liquidity, resulting in a higher bid-ask spread.

The size of the international bond market is estimated at \$45 trillion and the size of outstanding USD bond market is estimated at \$25.2 trillion¹.

The conventional debt secondary market has certain characteristics, such as,

- High liquidity, reflected by the large number of buyers and sellers and high trading volume (average daily trading volume for the US bond market is estimated to be \$923 billion²).
- Market depth meaning that the money market traders can execute large orders without compromising substantially on the price.
- Efficiency, indicating that the pricing reflects issuer credit strength, fundamental value of the investment and diversity in the participants (both issuers and traders)
- Well defined yield curve. Traditionally yield curve is observed to be upward sloping with approximately 200-300 basis points difference (reflecting liquidity risk premium) between long and short tenure maturities. A large deviation between short and long tenure yields can be due to temporary mispricing (subject to adjustment in near future) or due to fundamental reasons (not subject to adjustment in near future).
- Other useful curves, reflecting expectations for forward and swap rates facilitate pricing of the instruments. The forward curve is supposed to be an

¹ Bond Market Association

² SIFMA 2005 Average Daily Trading Volume

unbiased predictor of future spot rates and the swap curve is supposed to serve as a proxy rate for longer maturity instruments not readily available or traded in the debt market.

- Valuation of new and upcoming issues continually validates the pricing of outstanding issues set by actual trades.
- Credit risk premium is determined by credit strength of the issuer. Independent credit rating agencies provide credit opinions and these form the basis of risk based pricing.
- Interest rate risk resulting from changes in market interest rates affecting cash flows for variable rate securities and market value for fixed rate securities is controllable with the help of derivatives.
- Despite high liquidity and a large number of issuers, debt markets are not as fast moving as equity markets, and unlike organized exchanges for equity, debt instrument trading in the secondary market is decentralized (also called over-the-counter (OTC) market). i.e. it is done through direct interaction of buyers and sellers with the help of dealers.

Liquidity Management by Islamic Financial Institutions - Barriers and Issues

Liquidity management by Islamic Financial Institution is constrained by a number of issues. These arise due to a number of reasons including market driven factors (deficiencies in the market instruments), limited choice of instruments available to Islamic Investors, regulatory environment and lack of insight into the information and risk profile of Shari'a Compliant Instruments. Let us discuss these issues in some detail.

Market Driven Factors

Islamic debt issuance is relatively new compared to conventional debt which has been in existence for a long time. The secondary market for Islamic instruments lacks key features required for efficient functioning of the debt market, such as;

- A consensus Islamic benchmark rate because of which conventional market benchmark rate (such as Libor or Euribor) is used as a proxy to determine the pricing of the Islamic instruments
- Low liquidity, suboptimal market depth, lack of efficiency and relatively small number of participants

- Lack of price validation mechanism which facilitates issuance of new and upcoming issues
- Absence of a focused risk based pricing mechanism (a demand for credit ratings with a focus on Islamic finance can provide this mechanism)
- Mitigants to manage and hedge the risk of fluctuations in the market value of instruments on account of movements in benchmark rate.
- Limited choice of assets to be used as collateral.

Limited number of instruments

Currently the Islamic debt market consists of Sukuk which are bonds that can be structured in a number of ways to reflect the various modes of Islamic finance. Some examples are Ijarah Sukuk and Al-Salam Sukuk. Besides Sukuk, Islamic banks use interbank borrowing and placement for short term liquidity management through the use of commodity Murabaha.

Due to a lack of products or assets in which to invest their money, IFIs are finding it increasingly difficult to manage temporary and/or short-term excess liquidity. In addition to a regulatory environment which is still evolving, another factor constraining efficient Islamic financial markets that can provide liquidity management instruments is the pricing issue and informational limitations. Since investors with a preference for Shari'a compliant products may have limited appreciation of the risks and rewards associated with such investments, the secondary market has not developed for such instruments.

Impediments to Securitization

It is a given that Islamic institutions conduct the major part of their business in the Muslim world. Securitization is common primarily only in countries with a developed regulatory framework such as the OECD countries and a few emerging economies like Singapore and Malaysia. The regulatory environment, in the countries where the demand for Islamic finance is the strongest, needs to be made supportive of the evolution of Islamic finance products.

Securitization has not been used by Islamic banks because of lack of demand. This lack of demand arises because of the underleveraged status of the balance sheet of most of the Islamic banks. Demand for securitization is typically felt by banks having high level of disposable risk assets compared to capital. Securitization is also done to remove a class of assets from the balance sheet to reduce the strain on the capital. This situation will arise once the Islamic banks

will be able to grow to adequate size in relation to the resources available to them.

Why is there a Buy and Hold Culture?

Buy and hold strategy is the opposite of active portfolio management of debt securities. With a buy and hold policy the portfolio manager normally buys a security and holds it to maturity. He may decide on a percentage allocation of the total portfolio in the various instruments at the outset, and then maintain that portfolio composition.

Unlike theoretical efficient markets where active trading is not supposed to be a beneficial strategy, since the market price of securities fully reflects the risk profile and return expectation of an instrument, secondary market trading in less efficient markets has incentives and rewards available to the portfolio manager capable of superior security selection and sector allocation.

There are a number of reasons that are responsible for buy and hold culture in the secondary debt market for Shari'a compliant instruments. These are

- Lack of trained personnel who can handle pricing and trading in the instruments
- Islamic financial institutions are often underleveraged. They also lack avenues to invest their money. This results in excess liquidity with little incentive to sell the existing instruments.
- Treasury managers may be forced to keep extra cash in order to support unanticipated demand which may be inconsistent with the budgeted amount.
- Treasury is viewed as a cost centre acting as custodian of the vault of the bank. In such a situation treasury managers are not expected to generate profit.
- Internal pricing mechanism is designed properly to assess actual cost of the funds.
- A final reason for lack of trading in Sukuk issues is the settlement problem associated with Sukuk's lack of adherence to international bond

conventions. Most important of them is its having a Euro clearable status. Euro clearable status enables quick and efficient transfer in case of a change in ownership of the instruments.

Despite impediments, the demand is there:

Despite the impediments discussed above, demand for Islamic finance instruments exist because of the desire to earn short term trading profit and to manage the short-term and in some cases medium to long-term liquidity. In addition to these two major incentives, other incentives for trading are

Yield Pickup Trade- The manager may find the risk quality difference between say a AA rated instrument and an A rated instrument unimportant and trade in A rated instrument (offering higher yield) against AA rated instruments.

New Issue Swap- managers may prefer to swap on-the-run issues with old issues since on-the-run issues are perceived to provide greater liquidity. The manager might be interested in changing / rotating sector exposure. And changing/ altering portfolio duration may also be a reason for trading in the secondary market.

Credit-upside trade- As soon as a credit upgrade is announced for a security, the yield spread on that security narrows causing a corresponding increase in the market price. Under-rated and therefore undervalued securities are purchased to profit from any probable credit upgrade.

Credit defense trade- As soon as the credit downgrade is announced the security price declines reflecting the wider yield spread. To prevent this loss, overvalued securities are divested.

Sector rotation trade- To change sector exposure issues in one sector are swapped against issues in another sector. It is usually done to adhere to the benchmark allocations stipulated in the investment policy.

Yield curve adjustment trade- To shift/ modify portfolio duration

IFIs have stronger needs for liquidity than conventional banks because of the fact that their reliance on lender of last resort is to some extent limited (i.e. only

up to the extent to which the central bank provides Shari'a compliant funding support).

With this we arrive at a conclusion that the buy and hold culture (where Institutions prefer to hold the instruments till maturity rather than trading them in secondary market) that we see prevalent in Middle Eastern markets and specifically in Islamic Financial markets is due to supply constraints, where the choice in the instruments is limited and the demand for the instrument despite the presence of incentives to trade is discouraged because of the impediments as discussed above.

The Path to Liquid Secondary market:

As discussed, liquidity in the secondary market is a function of demand and supply of Islamic financial instruments and value changes that offer profit opportunities. These are **market driven factors** (arising due to inefficiencies in the market), the **limited choice of instruments** available to Islamic Investors, **regulatory environment** and **lack of insight into the risk characteristics of Shari'a Compliant Instruments**.

To remove inefficiencies in the market, the following measures are available:

- Evolution of a consensus Islamic benchmark rate beyond LIBOR
- Increase the number of market participants offering a variety of new Islamic instruments catering to a wider selection of investors.
- Refinement of price validation mechanisms based on prices set in the market which will facilitate further issuance of new and upcoming issues
- Evolution of ratings-based pricing to ensure proper allocation of capital.
- Deployment of derivatives and structured products designed to hedge the risk of fluctuations in market value resulting from movement in rates, such as swaps and forwards.
- As observed in the case of various stages of development in the conventional debt market, availability of the Shari'a compliant debt instruments will grow with the level of acceptability and understanding of the same.

The Regulatory environment is evolving and it has to be able to support the financial engineering innovations, the cornerstone of efficiency in the debt market. The stages of evolution that the developed countries have witnessed in the development of conventional debt market suggest there is no quick fix. The process is gradual where the regulatory environment in the first place has to provide a level playing field for all the existing players in the market and then

gradually with evolution of new products and instruments it has to keep pace with new developments.

The Path to liquid secondary market- Role of a Credit Rating Agency

Our role is to facilitate the flow of information from the issuer to the investors, and to convey the import of that information in the form of an independent informed opinion regarding the issuers in a language that participants can understand and rely upon. The role of a credit rating agency focused on Islamic finance should be to educate investors at individual and institutional levels about the quality of instruments covering such aspects as:

- Probable future net free cash flow, core earnings and sustainability in the earning power of the issuers
- The structure of instruments based on Islamic principles.
- Shari'a products and their level of compliance with Shari'a guidelines.
- The regulators' support for Islamic modes of Financing, the incentive/disincentive to Islamic Banking in the economy, and the presence of separate sets of rules governing Islamic Financial Institutions.
- The extent of knowledge and awareness of Shari'a and commitment to adhere to Shari'a laws in letter and spirit by the top management of the issuer.
- The capital adequacy focused on core capital and core funding with an assessment of the ability of existing resources to support the risk profile of the organization.
- The characteristics differentiating Islamic financial institutions from conventional institutions.

Are the complex Instruments more difficult to trade?

The answer lies in the analysis of trading in various conventional plain vanilla and exotic instruments. As the financial markets reach maturity, the participants start realizing the need to manage various risks inherent in such instruments. The market responds and product innovations lead to development of structured financial products. Initially plain vanilla products such as interest rate swaps and forward rate agreement were introduced. To meet the needs of various other participants, inclusion of certain options in the securities resulted in structuring of various mortgage-backed and asset-backed securities. To sum it all, financial instruments continue to become more complex as time passes and as the need for hedging is felt by market participants. Finally, we saw complex structured

products such as instruments with floors and caps and swaptions, which combine more than one derivative or a number of options in a single product.

The interesting point to note here is the fact that the complexity is a function of evolution in the market and the level of maturity the market has realized. It has never been a question of one instrument being more difficult to trade than another. Rather it is always a question of what the needs of the market participants are. At a primary level where the rudimentary instruments have not achieved the acceptability for all participants, the issue to be focused on is to make sure that level playing field is provided for further developments of the market. The complex instrument will create their own demand once the participants are comfortable with what they are being offered at this point in time.