Sukuk

A Global Trend

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– Jamal Abbas Zaidi

CEO, Islamic International Rating Agency (IIRA), Bahrain

Islamic bonds or *'sukuk'* have generated considerable interest in international capital markets. *Sukuk* are a type of financial certificate, comparable to conventional asset-backed securities that provide investors with ownership in a specified underlying real asset found on the balance sheet of the issuing company. The *sukuk* model is effectively a derivation of the conventional securitization process, where a special purpose vehicle acquires control of the originator's real assets and issues financial claims on the associated cash flows. Investors receive a 'profit rate' based on the revenue streams of the underlying asset instead of traditional interest payments. Such a structure qualitatively enhances the security of the investment and reduces a typical investor's risk exposure. International investors have the added benefits of portfolio diversification. With returns normally benchmarked against the London Inter-Bank Offered Rate, *sukuk* are priced competitively against other financial products floated in developed and emerging markets.

Indeed, the key selling feature of an Islamic *sukuk* is its involvement in the funding and/or production of real assets. Under a *Sukuk-Al-Murabaha* structure, commodities are initially purchased and then resold to the specified client at a mark-up with temporary ownership used as justification. *Sukuk-Salams* are similar to *Murabahas* with the exception that investors entering into the contract pay for delivery of the underlying asset at contract initiation. *Sukuk-Al Istisna'a* structures are based on pre-production payments used to finance the manufacturing capacity of the issuing company while *Sukuk-Al Ijara* involves the leasing of real assets, rationalizing the payment of rent to the owner. *Sukuk-Al Musharakah* is structured when both issuer and lenders participate in a joint business venture, necessitating investment in tangible assets and profits shared at an agreed upon ratio. *Sukuk Al-Mudarabah* is structured slightly differently where investors lend funds to a *mudarib* (or entrepreneur) who undertakes to invest these proceeds in real assets and shares a percentage of the profits generated.

Sukuk structures do contain covenants specifying the underlying asset mix with restrictions on underlying debt concentration. Indeed, certain *sukuk* issuers have been limited to a maximum debt concentration to 35% of a company's total assets. This lessens the harmful effects of an over-leveraged company and lessens the probability of default. Similarly, scholars advising *sukuk* structures have mandated that the financing income be restricted at 10%, thus ensuring that the company's assets are being actively used to generate returns. The debt covenant may find appeal among certain risk-averse investors unwilling to tolerate the large debt proportion in the firm's capital structure. Financing income caps may not be as welcomed by investors given a less predictable cash flow stream and the greater variability of returns being generated by the underlying asset.

Global interest in *sukuk* can be partly attributed to the limited secondary market in the GCC region. Financial institutions in the Middle East have little trading experience and generally tend to buy and hold *sukuk* issues. Western investors incorporate sophisticated investment strategies and are likely to acquire *sukuk* for generating capital gains. In this regard, European funds have shown the strongest interest by far in *sukuk* followed by Asian-based investors. The security's tenor is an added bonus with *sukuk* having wide ranging 'terms to maturity'; those investors with different investment horizons can acquire *sukuk* issues to meet their return objectives.

Issuers find Islamic *sukuk* attractive primarily because they are useful in raising both short and long-term capital needed to finance large infrastructure projects, real estate development and corporate expansion. The varied *sukuk* maturities should interest corporate issuers and financial institutions which will utilize *sukuk*-financing for asset and liability management purposes in order to avoid funding mismatches. *Sukuk* yields are 10 to 20 basis points lower than conventional mainstream bonds enabling issuers to benefit from raising funds in the Islamic bond market. The impact of *Shari'ah* compliance will necessitate funds raised through *sukuk*-financing to be utilized in generating appropriate returns for investors while avoiding high risk investment opportunities, and other unsuitable activities such as gambling and alcohol production. Issuers based in non-Muslim countries (as well as Arab/Muslim countries) can also tap the cash rich GCC investors who are increasingly looking to invest in *shari'ah*-compliant financial products. Issuers can now confidently achieve diversification in their sources of funding as major investment houses offer the requisite underwriting/book-running services.

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Sukuk are gaining acceptance in international capital markets. A limited number of *sukuk* have been listed on the Labuan International Financial Exchange (LFX) in Malaysia, the Dubai International Financial Exchange in the UAE, the Bahrain Stock Exchange (BSE) in Bahrain and the Tadawul in Saudi Arabia. Issuers have also listed on the Luxembourg Exchange in Luxembourg and the London Professional Securities Market in the UK to meet the growing international demand for *sukuk*.

The *sukuk* bonanza

Since its inception in September 2001, with the debut \$100 mn *Sukuk Al-Ijara* sovereign issue of the government of Bahrain and the December 2001 \$150 mn First Global *Sukuk* Inc. sovereign issue by the government of Malaysia, the global *sukuk* market has grown at an average annual rate of 40% plus. Current analyst consensus estimates of the total Islamic Bond market, considering both domestic and international *sukuk* issues, are projected to be \$50 bn. As of July 2007, the total global *sukuk* amount tracked by the Bahrain-based Liquidity Management Center for secondary trading purposes stood at \$24.46 bn. Total *sukuk* sizes listed on the various international exchanges are as follows:

Aggregate Listings on International Exchanges	
DIFX	\$13,780
LFX	\$4,575
Luxem	\$3,200
Tadawul	\$2,133
BSE	\$2,065

Note: Figures in \$ Million/Dual listings are present (July 2007).

The primary advantage of the *sukuk* is the enhanced quality it brings with the presence of an underlying tangible asset. Appropriate underlying assets have the capacity to not only produce the revenue streams desired by investors but allow even struggling entities to pledge their most profitable assets for *sukuk*-financing. The fact is that *sukuk* are backed by hard assets limiting the possibility of issuer default. *Sukuk* are attractively priced and provide competitive returns at par with other corporate issues; its structure appeals to all types of investors including fund managers, insurance companies and investment banks.

The *sukuk* market will also be best placed to serve efficient resource mobilization for Arab/Islamic countries to meet their growing funding needs. Spending on infrastructure in Asia and the Middle East alone has been projected at \$1.5 tn over the next five years and the *sukuk* market will be an avenue issuers will explore to fund their long-term productive-investment plans. The growth of the Islamic bond market will be fundamental in the development of both institutional investors seeking to diversify their portfolios and corporate/sovereign issuers looking to diversify their sources of funding within the confines of *Shari'ah*. The overall effect is the development of stronger capital markets across the Islamic world and global acceptance and viability of alternative financial products. For Arab/Islamic countries this translates to a balanced allocation of financial and economic resources, diversification of risks across the Islamic financial system, and greater internal economic resilience and stability.

The growing pains of a *sukuk* market

Liquidity has always been a concern for *sukuk* although it has become an increasingly diminishing one. The establishment of the Liquidity Management

Center (LMC) in February 2002, part of a larger project to develop an International Islamic Financial Market (IIFM), led to the formation of an Islamic inter-bank money market. The creation of this secondary market has allowed the LMC to provide competitive returns on short-term liquidity investment opportunities enabling Islamic financial services institutions to manage their liquidity more effectively. A continuous flow of Islamic papers and instruments will still be needed to promote secondary trading and enhance market depth. At present, the size of the secondary market is relatively small although secondary trading of *sukuk* is on the rise. Current estimates of daily *sukuk* trading volumes are projected at $80-100 mn. Across the Arab/Islamic world, secondary debt trading remains largely decentralized with transactions occurring primarily over the counter with a few trained personnel who can handle trading and pricing issues.

The absence of a consensus Islamic benchmark rate (like LIBOR or EURIBOR), and consequently an established benchmark yield curve, is an added constraint. Developing a consensus rate will be critical for pricing both existing and outstanding *sukuk* issues. Yields should be ratings-based to reflect inherent risks and ensure the proper allocation of investment capital. Prices of some *sukuk* are not as easily available to the investing public but in time the development and consolidation of regional *sukuk* markets is expected to make such concerns irrelevant.

Access is an additional limitation as the sale of *sukuk* is presently restricted to wholesale investors. Licensed finance professionals are allowed to invest directly, while other market participants are excluded from the investing process. Similarly, *sukuk* issues have a settlement problem given their lack of adherence to international bond conventions. *Sukuk* will need to have Euro-clearable status to ensure quick and efficient transfer of ownership.

The lack of transparency is another problem particularly across the Middle East North Africa region. If issuers are to attract and retain capital from international investors they must seek to match the highest disclosure standards possible. Similarly, *shari'ah* experts should be willing to disclose their '*fatwas*' or juristic reasoning, in order to gain wider acceptance of *shari'ah* decisions given the implications these opinions will have on cross-border transactions. The current regulatory framework in GCC countries is still below international best practice especially in areas of corporate governance, although governments and the burgeoning GCC private sector are making amends, seeking to rectify the apparent lack of transparency.

The Arab/Islamic countries may also need to amend existing finance regulation to better suit the needs of the *sukuk* market and evolution of Islamic finance products. A case in point is Indonesia where the *sukuk* market has struggled to take off due to the legislation in place governing the treatment of capital gains tax. The United Kingdom has itself only recently introduced legislation that will seek to provide *shari'ah*-compliant bonds with the same tax relief offered to conventional bonds; the draft legislation (Finance Act 2007) still awaiting UK parliamentary approval.

Standardization of *sukuk* should be a welcome relief for investors and issuers alike although the process has been a slow and cumbersome one. Both the Auditing Organization for Islamic Financial Institutions (AOIFI) and the Islamic Financial Services Board (IFSB) have formulated standards for the prudential treatment of *sukuk* investment by Islamic financial institutions. Of late, differences in opinion have developed between GCC-based scholars and their Malaysian counterparts. In Malaysia, a substantial number of *sukuk* are now being backed by Islamic Private Debt Securities. Scholars differ over the suitability of using debt-backed *sukuk* and question whether such a structure even conforms to the widely agreed upon principles of *shari'ah* governing Islamic finance.

Finally, new *sukuk* offerings if not managed properly have the potential to imitate existing *sukuk* issues limiting investor appetite. Investors will need to assess both the suitability of underlying assets as well as *sukuk* structure. The ideal approach for correcting potential imitation is for market participants to encourage greater financial engineering and innovation in *sukuk* structures thereby enhancing variety. The global demand for *sukuk* issues far outstrips supply and market makers must be geared to address these challenges.

The hazards for a *sukuk* investor

Investors face multifaceted risks that are not all unique to *sukuk* issues. The recent subprime crisis in North America is a testament as to how sensitive *sukuk* issues have become with movements in international markets. Both Dana Gas and Ithmaar Bank delayed their *sukuk* pricing recently due to the unfavorable interest rate environment. It is worth noting that a substantial number of issued *sukuk* go unrated. Unlike Malaysia, GCC countries do not require issuers to seek ratings either before or after the *sukuk* launch forcing investors to do the required due diligence and research themselves. The Islamic International Rating Agency is well-placed to step in and meet the capital market requirements by providing the requisite *sukuk* ratings. Issuers and investors will now have access to qualitatively superior information and should be in a position to make better and more informed financing/investing decisions.

Specifically, investors are exposed to a variety of risks identified below:

Rate of return risk (Interest rate risk)

Rate of return risks on all types of fixed rate *sukuk* is always a concern for investors with upside return potential capped and investors receiving the fixed rate during the life of the *sukuk*. Similarly, returns benchmarked against LIBOR make exposure to changing interest rates a natural consequence, although the impact is less pronounced compared to fixed rate *sukuk*.

Credit risk

Credit risk on fixed rate *sukuk* should also be factored in by investors given the possibility of external counterparties defaulting on rent payments to the underlying asset. Counterparties will be more willing to default as debt rescheduling at higher interest rates is not permissible under Islamic laws. Credit risk of the special purpose vehicle and originator will need to be assessed independently especially if the lender has access to recourse and the underlying assets fail to cover creditor losses.

Foreign exchange rate risk

Foreign exchange rate risk is another worry particularly if the underlying asset is generating returns in a foreign currency. Originators themselves may need to act as guarantors by assuming FOREX risk exposures thereby shielding investors from unfavorable exchange rate movements. Ideally, the underlying asset pool would need to be well-diversified generating multiple currency returns to completely offset the foreign exchange impact for both originators and investors. The term of maturity of *sukuk* also matters given that smaller maturity *sukuk* will be less exposed to long-term exchange rate changes.

Price/Collateral risk

Price risk is asset-specific given that there will be differences in the fair-market and reported values of the underlying asset. The underlying tangible assets are likely to depreciate and maintenance will surface as an issue. *Ijara Sukuk* will be considerably vulnerable to such risk exposure as depreciation of the leased asset will likely cause asset values to fall below prevailing market values. *Salam Sukuk* does face price risks, but such risk can be mitigated with investors entering into parallel contracts with third parties.

Liquidity risk

The limited growth of the secondary market poses its own challenges to those investors seeking to trade/liquidate their holdings. Pricing, market depth and volume issues add to the real concerns investors have with selling their *sukuk* certificates. The buy and hold culture as well as decentralized secondary trading prevent investors from seeking an efficient transfer of *sukuk* certificate ownership without loss of value.

Similarly, *Salam Sukuk* and *Zero Coupon Sukuk* are themselves entirely non-tradable. Scholars opine that because *Salam Sukuk* contracts are based on underlying grains (and other food commodities) trading of such securities may result in speculation or undue exploitation. *Zero Coupon Sukuk* such as *Sukuk Al-Istisna'a* and *Sukuk Al-Murabaha* do lead to debt ownership; trading of debt securities being incompatible with Islamic *shari'ah*.

***Sharia'a* compliance risk**

As seen with the Malaysian debt-backed *sukuk*, a great deal of standardization and awareness of *shari'ah* rulings will be needed. Given the tremendous growth in *sukuk* markets the non-compliance of *sukuk* structure with *shari'ah* rulings remains a possibility. Muslim investors will need to be particularly careful to ensure selection of those *sukuk* that are of the highest *Shari'ah* quality and are conforming to widely accepted *shari'ah* standards.

Future outlook

The outlook for Islamic *sukuk* is promising with tremendous scope for innovation and variety. According to the Islamic Finance Information Service, the first half of 2007 has alone registered almost $24.5 bn of new *sukuk* issues. Analysts project that the *sukuk* market will reach the landmark $100 bn within the next three to five years given the expectations of market consolidation, wider international outreach with non-Muslim investors/issuers, and development of uniform *shari'ah* rules governing *sukuk*. The Capital Market Authority in Saudi Arabia has recently raised the individual *sukuk* ceiling to SR8 bn (Est. $2 bn) and Kuwait has proposed to relax its regulations governing *sukuk*-financing. These are promising initiatives although more work is needed to mitigate the current risks and limitations of the regional *sukuk* market.

Sukuk is all set to emerge as an important congruent of the global Islamic financial system.

Arab/Muslim investors are increasingly choosing Islamic financial products and services over conventional ones and there is recognition among market participants that *sukuk* are an acceptable and viable alternative investment. The Islamic finance and banking industry as a whole stands at $700 bn and is expected to double by the end of the decade. Certainly, *sukuk* will play a significant role in the industry's development and should be considered a key driver of its growth. In short, *sukuk* is all set to emerge as an important congruent of the global Islamic financial system. The *sukuk* market will also serve as an important platform, complementing the conventional bond market in enhancing the mobilization and allocation of funds across international capital markets.■

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