The Role of Sukuk in Islamic Capital Markets (ICM)

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PART 1: OVERVIEW OF SUKUK AND ICM

1 INTRODUCTION: SCOPE & METHODOLOGY

2 ROLE OF SUKUK IN ISLAMIC CAPITAL MARKETS

3 KEY SUCCESS FACTORS IN DEVELOPING A SUKUK MARKET

4 GLOBAL DEVELOPMENT OF SUKUK STRUCTURES, ISSUANCES & INVESTMENT

5 KEY ISSUES & CHALLENGES IN DEVELOPING SUSTAINABLE SUKUK MARKETS
Objective:
To analyse the role of sukuk as an instrument for capital market development and resource mobilisation, and as an alternative financing tool for the economic development of the public and private sectors.

Scope:
Methodology of the study

Methodology:
- Literature review
- Data analysis of data from various industry & economic reports and macroeconomic data
- Primary data from Bloomberg and Eikon-Thomson Reuters
- Online survey of more than 50 market respondents
- Phone calls and face-to-face meetings
- Field visits to Indonesia, Turkey & Nigeria
Evolution of the sukuk industry

Historical
- Classical use of sukuk
  - Commodity/grain coupon
  - Esham

Pre-1990
- Initial attempts to develop sukuk
  - Muqaradah bonds
  - Participation terms cert
  - GII

1990-2000
- Early sukuk issuance
  - Shell MDS sukuk
  - Period of theory and model building

2001-2016
- Emergence of sukuk markets
  - Bahrain government ijarah sukuk
  - Malaysian global sukuk

2017 - Future
- Expansion of sukuk markets
  - Green sukuk
  - More jurisdictions issuing sukuk
“The CAGR of Islamic finance assets from 2012 to 2017 stood at 7.4% with total assets of USD2.4 trillion as at end-2017 (projected)”

Source: ICD-Thomson Reuters Report 2017
As at end-2017, global sukuk issuance increased 45.4% to USD105.6 billion from USD72.6 billion end-2016.

In 2017, GCC sukuk issuance improved significantly by 144.5% to USD46.9 billion from USD19.2 billion in 2016. Performance was driven by higher issuances from the public sector jumping to USD31.9 billion from USD3.7 billion, of which Saudi Arabia’s market share stood at 77% (or USD24.6 billion).

Source: Eikon-Thomson Reuters, Bloomberg, Bank of Indonesia, Capital Markets Board of Turkey.
A snapshot of global sukuk as at end-2017 (con’t)

- From total global sukuk issuance, public sector issuance made up 58.5% (or USD61.8 billion) and private sector comprised 41.5% (or USD43.8 billion)

- On the private sector, Malaysia and GCC hold the highest market share. End-2017, Malaysian corporates represented a dominant 60.0% (or USD26.3 billion) followed by Saudi Arabia at 16.2% (or USD7.1 billion) and UAE at 9.0% (or USD3.9 billion) of total private sector issuance

Source: Eikon-Thomson Reuters, Bloomberg, Bank of Indonesia, Capital Markets Board of Turkey
SIX KEY DOMESTIC MARKET STAKEHOLDERS

**EXCHANGES**
Generate investor confidence

**REGULATORS**
Attract foreign investors and strengthen the liquidity structure

**GOVERNMENT**
Promote the efficient use of domestic wealth through financial intermediaries

**SERVICE PROVIDERS**
Stimulate activity and product development in both the sell and buy sides

**NBFIs**
Facilitate issuance of infrastructure-based sukuk with long tenures

**FINANCIAL INSTITUTIONS**
Promote value creation through capital-market activities

**A SUSTAINABLE SUKUK MARKET**
Key international institutions in developing sukuk markets

**Key role:**
To issue short-term Shariah-compliant financial instruments (i.e. short-term sukuk) to facilitate more efficient liquidity management for IFIs and to support cross-border transactions between these institutions.

**Key role:**
To develop and issue innovative Shariah-compliant sukuk structures to fund its member countries.

**Key role:**
To issue sukuk that promote shared prosperity and socially responsible investment (SRI).
McKinsey’s building blocks...

Capital Markets
- Government bonds
- Corporate and financial institution bonds
- Equity
- Securitised products

1 Foundational policies
- Benchmark assets
- Supply of capital
- Demand for capital
- Intermediation
- Free markets
- Price discovery

2 Regulatory framework
- Regulatory bodies and their architecture

3 Cornerstone institutions
- Governance and ownership
- Institutional setup

4 Regulations and standards
- Transparent regulations
- Predictable enforcement

5 Taxation
- Tax policies
- Tax incentives

6 Market infrastructure and technology
- Market infrastructure
- Technology

Critical success factors for establishing a sustainable sukuk market

1. Cohesive collaboration with key market stakeholders:
   ✓ A specific roadmap for the inclusion of ICM, interlinking sukuk as a core component is key to guide and measure the effectiveness of participation level

2. Vibrant ecosystem:
   ✓ Amalgamation of a strong legal and regulatory regime, coupled with a conducive tax environment and robust market infrastructure and technology

3. Intermediation of domestic financial resources:
   ✓ Effective mobilisation of domestic financial resources through cornerstone institutional investors such as pension funds, insurance/takaful companies, etc.

4. Sustainable supply of private sector:
   ✓ The best yardstick in tracking the pulse of a local sukuk market is the performance of the private sector (i.e. quasi-government and corporate issuance)

5. Shariah governance framework:
   ✓ Harmonisation of Shariah principles and interpretations adds clarity to product development, builds market confidence and creates awareness of the benefits of Islamic finance
Despite the existence of international Shariah guidelines, AAOIFI Shariah standards are not binding.

Each jurisdiction has evolved differently to accommodate the Shariah-related needs and requirements of its domicile country.
Global development of sukuk structures (con’t)

“Ijarah-based sukuk constitute a large portion of sovereign issuances in most jurisdictions”

Types of Shariah contracts for sovereign issuances by selected Arab countries (2011 - June 2017)
Global development of sukuk structures (con’t)

Types of Shariah contracts for sovereign issuances by selected Asian countries (2011 - June 2017)
Types of Shariah contracts for sovereign issuances by selected African countries (2011 - June 2017)
Global development of sukuk structures (con’t)

“Requirement of having to secure available unencumbered assets has pushed the commercial decision by governments and corporates to adopt wakalah contracts”

Types of Shariah contracts for quasi-government and corporate issuances by selected Arab countries (2011 - June 2017)
Global development of sukuk structures (con’t)

Types of Shariah contracts for quasi-government and corporate issuances by selected Asian countries (2011 - June 2017)
Global development of sukuk issuances – Arab region

“Arab countries have been actively issuing both LCY and FCY sovereign sukuk to finance their budget deficits”

GCC’s and Jordan’s sovereign and corporate (including quasi-government) sukuk issuance (2013–June 2017)
Global development of sukuk issuances – Arab region (con’t)

“In developing Arab countries’ sukuk markets, consideration should be given to the large infrastructure funding gap that has historically been funded by governments and commercial banks”

Arab countries’ infrastructure spending

Infrastructure financing gaps
- USD100.0 billion
  - Annual funding gap of USD60.0 billion
- USD40.0 billion

Current Spending
- Investment Requirements
- Priority sectors for the next 5 years
  - Water and Sanitation: 5%
  - Transport: 43%
  - Information and Communications Technology: 9%
  - Electricity: 43%
Financial institutions have been the core sector raising sukuk to meet capital adequacy requirements. Sectoral diversification can be observed in quasi-government and corporate sukuk issuances originated in Indonesia and Malaysia.

The GoM’s concerted efforts to include Islamic banking and Islamic finance as policy tools in its economic agenda have been the driving force behind the country’s rise in the mainstream financial markets.
Global development of sukuk investment – Arab region

“A snapshot of selected GCC’s credit investors profile

Investors in GCC’s recent bond issuances (including sukuk) shows a high reliance on foreign investors”

Financial Intermediation by NBFIs as a Percentage of GDP (Arab)

<table>
<thead>
<tr>
<th>Country</th>
<th>NBFIs assets as % to GDP</th>
<th>Pension fund assets as % to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>31.5% (2014)</td>
<td>20.5% (2006)</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2.44% (2014)</td>
<td>n/a</td>
</tr>
<tr>
<td>Oman</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Qatar</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>14.4% (2014)</td>
<td>26.0% (2016)</td>
</tr>
<tr>
<td>UAE</td>
<td>n/a</td>
<td>2.7% (2007)</td>
</tr>
</tbody>
</table>
Global development of sukuk investment – Asian region

“Hong Kong and Malaysia have undergone healthy developments in terms of the composition of their financial markets. Indonesia is still attempting to establish a higher ratio of its outstanding bond market against its GDP.”

### McKinsey Asian Capital Markets Development Index

<table>
<thead>
<tr>
<th>Country</th>
<th>Funding at scale¹</th>
<th>Investment opportunities²</th>
<th>Pricing efficiencies³</th>
<th>Total score (out of 5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td>4.00</td>
</tr>
<tr>
<td>Australia</td>
<td></td>
<td></td>
<td></td>
<td>3.95</td>
</tr>
<tr>
<td>South Korea</td>
<td></td>
<td></td>
<td></td>
<td>3.45</td>
</tr>
<tr>
<td>Singapore</td>
<td></td>
<td></td>
<td></td>
<td>3.40</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td></td>
<td></td>
<td>3.25</td>
</tr>
<tr>
<td>Thailand</td>
<td></td>
<td></td>
<td></td>
<td>2.80</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td></td>
<td></td>
<td>2.45</td>
</tr>
<tr>
<td>India</td>
<td></td>
<td></td>
<td></td>
<td>2.30</td>
</tr>
<tr>
<td>Philippines</td>
<td></td>
<td></td>
<td></td>
<td>2.25</td>
</tr>
<tr>
<td>Indonesia</td>
<td></td>
<td></td>
<td></td>
<td>2.20</td>
</tr>
<tr>
<td>Pakistan</td>
<td></td>
<td></td>
<td></td>
<td>1.30</td>
</tr>
<tr>
<td>Vietnam</td>
<td></td>
<td></td>
<td></td>
<td>1.20</td>
</tr>
</tbody>
</table>

¹ Weight allocated: 50% while arriving at total score
² Weight allocated: 40% while arriving at total score
³ Weight allocated: 10% while arriving at total score

### Financial Intermediation by NBFIs as a Percentage of GDP (Asian)

<table>
<thead>
<tr>
<th>Country</th>
<th>NBFIs assets as % to GDP</th>
<th>Pension fund assets as % to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>n/a</td>
<td>37.4% (2014)</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.3% (2014)</td>
<td>1.69% (2011)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>n/a</td>
<td>57.9% (2014)</td>
</tr>
<tr>
<td>Pakistan</td>
<td>n/a</td>
<td>0.02% (2012)</td>
</tr>
</tbody>
</table>
Global development of sukuk investment – African region

- Based on the composite mix of investors, Africa’s debt securities are mainly held by foreign holders.
- Although African governments have implemented measures to heighten the development of NBFIs, challenges such as financial inclusion and a low savings rate have been hampering progress.

### Financial Intermediation by NBFIs as a Percentage of GDP (African)

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<th>Country</th>
<th>NBFIs assets as % to GDP</th>
<th>Pension fund assets as % to GDP</th>
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</thead>
<tbody>
<tr>
<td>The Gambia</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Nigeria</td>
<td>n/a</td>
<td>4.4% (2012)</td>
</tr>
<tr>
<td>Senegal</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>South Africa</td>
<td>120.3% (2014)</td>
<td>40.8% (2014)</td>
</tr>
<tr>
<td>Sudan</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>
### Key issues and challenges

<table>
<thead>
<tr>
<th></th>
<th>Legislative framework</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Common law vs civil law</td>
<td>Recognition of trust</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Tax law &amp; framework</th>
<th></th>
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<tbody>
<tr>
<td>2</td>
<td>Tax neutrality</td>
<td>Tax incentives</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Shariah governance framework</th>
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</thead>
<tbody>
<tr>
<td>3</td>
<td>Standardisation/harmonisation</td>
<td>Centralised Shariah board</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Corporate sukuk issuance</th>
<th></th>
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<tbody>
<tr>
<td>4</td>
<td>Sovereign benchmark yield curve for corporate issuers</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Diversified investor base</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>5</td>
<td>Intermediation of NBFIs</td>
<td>Local &amp; foreign investors from various institutions</td>
</tr>
</tbody>
</table>
Thank you