Sukuk: A Capital Idea

Neale Downes of Watson Farley & Williams takes a look at the latest Sukuk structures being used and the strength of its current and future market.

The current size of the Islamic finance market is estimated at between US$1.66 trillion and US$2.1 trillion, and there are expectations that this market will grow to US $3.4 trillion by the end of 2018. These figures look very impressive in isolation. However, it is important to realise that at present Islamic finance assets only represent a tiny percentage of the global financial market.

Although the wholesale banking market and the fund and private equity sectors have made valuable contributions to the development of the Islamic finance 'space', many commentators believe that the key to the further expansion of Islamic finance is actually through the global capital markets.

CAPITAL MARKETS AND SUKUK

Capital markets serve two vital purposes. First, they bring together those with, and those seeking, capital. Secondly, and possibly more importantly, they provide a secondary market where holders of securities can exchange them with one another. In fact, without this liquidity, investors would be less likely to purchase these instruments, for fear of being unable to dispose of them in the future.

Up until now there has been extensive commentary on Sukuk and its myriad forms. This has included articles on:

- those issuing Sukuk;
- the variety of uses to which the funds raised this way are applied; and

- even articles on problems around recourse and repayment when underlying borrowers get into financial difficulty. The extent of this coverage has helped ensure that Sukuk are not just a product which is understood or embraced only by parochial domestic or regional markets, but there is awareness of them on a global level. However, there is still a general misunderstanding of what they actually are.

WHAT ARE SUKUK?

Strictly speaking Sukuk are not (or should not be seen as) debt instruments, although they are often somewhat misleadingly called 'Islamic bonds'. They are also not 'IOUs' and they don't constitute debts. Instead Sukuk represent undivided ownership interests in assets or services or in a project or business. Each Sukuk will also have a face value which is based on these underlying assets.

More importantly, Sukuk are an example of an Islamic product which has been able to cross over into the mainstream and appeal to conventional investors, in particular those which are familiar with the securitisation market.

BUILDING INVESTOR APPEAL

In an attempt to appeal to investors who are familiar with corporate bonds, the vast majority of Sukuk issues to date have been structured on an asset-based, rather than asset-backed basis. There has tended to be no outright transfer of legal ownership of the asset pool and 'recourse' has still, fundamentally been, to the ultimate user of the funds raised and their balance sheet. Sukuk issues have a number of significant benefits, including:

- access to another funding tool and to a deeper, more varied pool of investors, for those raising capital;
- access to another instrument enabling those investing to vary their portfolio of assets and exposures;
- a means of raising awareness of the Islamic finance market generally;
- a means with which Islamic financial institutions can manage their asset-liability mismatches.

RECENT MARKET DEVELOPMENTS

It's a market which is changing – and two of the most recent developments have been the increasing number of different structures which are prevalent in Sukuk issues and the growing appetite for them from both sovereign and corporate non-Muslim obligors who want to tap capital markets, by issuing Sukuk.

In the early days, most Sukuk issues used an ijara (or leasing) structure, typically in a sale and leaseback arrangement and often 'supported' by land or buildings which were owned by the party who was raising the funds.

Having initially also been used regularly in the early and mid-2000s, musharaka and mudaraba structures then waned in popularity, because of adverse comments by prominent Islamic scholars on their Sharia compliance.

However, over the last three to five years, there has been a real surge in the numbers of new structures being used and the features being built into Sukuk, in order to give issuers more flexibility and ensure a broader appeal for prospective investors.

As a result, the market has seen a resurgence in partnership or profit sharing models being used which have been suitably modified to ensure Sharia compliance. There have also been a

significant number of issues which have come to market using wakala (or agency) as the core relationship between the originator and issuer and/or a hybrid of wakala and murabaha, subject to certain limitations on the percentage of intangible assets or murabaha receivables constituting the asset portfolio.

There has also been a growth in the number of convertible issues, multi-currency issues and issues using perpetual mudaraba, from banks who wish to enhance their Tier 1 capital ratios.

These structures provide greater flexibility because they are not as heavily reliant on the availability of tangible assets or assets which exist at the time of issue (so also allow the underlying pool to be substituted) and open up the possibility of longer dated Sukuk. This particular point is key, as it means borrowers can attract investors who are looking for a return which, in effect, mimics an annuity, such as pension funds or insurers.

Another exciting development has been the number of sovereign issues which have been made, both by Muslim states outside the traditional Sukuk 'heartland' of the GCC and Malaysia and more notably, by non-Muslim countries. Muslim countries entering this market for the first time include Turkey, Sudan, Senegal, Indonesia, Brunei and Pakistan. It is also thought Nigeria is likely to tap into the Sukuk market again following its debut issue in 2013. The enthusiasm being shown in Kenya also demonstrates the fast-growing interest in Islamic finance models being found in African and, particularly in the sub-Saharan countries.

Of the non-Muslim sovereign issuers, perhaps key amongst those in this pioneer group, are the UK, China (through Hong Kong), Luxembourg and South Africa. The dynamic or motivation for these issuances is, however, quite different. In the case of the non-Muslim issuers, transactions have largely been markers or 'halo' deals, which have been intended to promote the fact that the issuing country is, or wants to be regarded, as an Islamic hub for Europe and to provide evidence of their ability to structure and offer these products across the full range of financial sectors. In these cases, issue numbers have been very modest within the context of the country's overall financing needs.

PROJECT SUKUK

Meanwhile, most of the Muslim issuer countries have a pressing need to raise finance or to diversify funding sources, to meet increasing costs of providing infrastructure assets and services, which their young and growing populations expect their governments to urgently deliver. Huge amounts of infrastructure work is required both in the Middle East and Africa. Although liquidity fluctuates, many banks have pulled out of or scaled back their project finance exposures, particularly as a result of the additional capital costs which were imposed by Basle III and CRD IV. This has created a potential funding gap, which Sukuk may well provide a viable way to fill at least in part, whether in isolation or by complementing traditional funding sources.

There is also a strong synergy between the fundamentals of Islamic finance and its application for 'beneficial' projects, such as the provision of power and water, roads, rail links, schools and universities, and housing. It can also be argued that Sukuk is well suited to project finance as the finance is asset-based or backed and investors typically want stable, long-term returns. However, there are issues that will need to be addressed when using this route, including managing construction risks, inter-creditor issues and most notably, ensuring there is a workable process for obtaining waiver, variations or consents. Marshalling a group of banks which are familiar with project finance and the regional nuances found in the Middle East and Africa is one thing. Pulling together hundreds of disparate capital markets investors, who are principally focussed on steady cash flows, of course, may be quite another. One possible alternative application of Sukuk in this area can be in the context of refinancing once construction phase risks have been addressed or as a pre-cursor or complement to wider project financing. This later context was in fact very successfully demonstrated by the Sadara Chemicals Sukuk. The significant progress made by Sukuk in creating an ever deeper footprint for the global Islamic finance market has been evident in the incremental increases in year-on-year issues over the last decade. Participants in this industry have shown inventiveness in the way they have developed new structures and have been able to find fresh areas for using Sukuk, and this can only augur well for future use of this most adaptable financial instrument.

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