So Far

The journal of strategic thinking in Islamic finance

Volume 1 – Issue 4 – Sept 2010

yasaar media

Islamic Finance Think Tank

Editorial director: Paul McNamara

We welcome nominations for membership to the Islamic finance Think Tank. Readers can nominate others for membership – but no one can nominate themselves. Nominations, together with a brief description of the candidate, should be sent to media@yasaar.org

Special Supplements

From time to time we will bring readers of **So Far** special issues and supplements that do not fit in with our general publishing schedule. We welcome such manuscripts and papers although realistically we can only hope to publish a small number of those we receive.

Publication of these papers will be based exclusively on the basis that they contribute to the depth of Islamic finance thinking. It is a prerequisite for publication that these papers have not been published elsewhere before in order to ensure that we are giving exposure to writers who have not been successful in achieving exposure for their paper elsewhere.

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The subject of this issue is:

How do we fix the current crisis in the Sukuk market?

Issuance has virtually dried up in the GCC – is this fixable?

Are there lessons to be learned from Asia?

Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

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So Far – Volume 1 – Number 4 – Sept 2010

Each issue of **So Far** will be devoted to a single topic of current relevance to the Islamic finance industry.

Each contribution to the Journal will be from a participant and practitioner within the Islamic finance industry rather than from an academic. The idea is that each issue will stimulate debate and discussion within the industry amongst practitioners and in so doing will provide some much needed airing of difficult issues.

We would encourage readers to share their own views with us on whether they agree or disagree with the views expressed within **So Far**. Opinions, thoughts and contributions should be sent to media@yasaar.org and we will review these contributions for inclusion in subsequent issues. Only those contributions that add depth and colour to the debate will be considered for publication**.**

The opinions expressed in the various contributions are those of the authors themselves and do not represent the views of the organizations for which they work or of Yasaar Media.

Paul McNamara

Dubai, UAE

How do we fix the current crisis in the Sukuk market? Issuance has virtually dried up in the GCC – is this fixable? Are there lessons to be learned from Asia? Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

Learning to fly

There is a crisis in the Islamic debt capital market, of that there is little doubt. While it is true that the raw figures for Sukuk issuance throughout 2010 look respectable enough at first glance, event a swift look at the detail reflects the fact that the GCC has been something of a no-show this year.

The GCC has traditionally been a powerhouse in Sukuk issuance, so this 'falling behind' that we have seen has to be taken seriously and is worrisome indeed. I had the great fortune to talk to a couple of senior Sukuk figures during the summer at a conference in Oxford and they were at great pains to blame the media for any perceived problems that might be afflicting the Sukuk space. I should add that they were not tilting at me in particular, but rather at a rather better known UK-based financial newspaper which they blamed for scaremongering.

It might come as little surprise to readers to learn that my sympathies lie more with the media than with the Sukuk specialists. To that end I asked them why there had been no issuance of any great note from the GCC (Saudi aside) since the start of the year. Their response was that institutions in the GCC were flush with cash had no need to issue debt, particularly with interest rates so high. There was a recession on and therefore institutions were being prudent and deferring any sort of investment that was not pressing.

Clearly I can see that there is some logic in this although the overall tenor of the discussion seemed to mask an undercurrent of desperation. The Islamic finance industry has never been good at bearing its soul and it has never been good at staring at the unvarnished truth. It is far happier hiding behind the skirts of 'custom' and blaming transgressions on honest errors of judgment and lack of experience.

But here we have a drama that is truly a crisis. At present few investors are willing to invest in Sukuk outside of the Malaysian market and the reasons are were known and well understood. There is the core question of asset-backed versus asset-based, of course. The issue here is whether, in the event of a default, the investor in the instrument has recourse to the asset underlying the structure. For western investors, particularly the big institutional investors, this is rather a key point. And it is for this reason that we are not likely to see much large scale institutional investor interest in Sukuk for the foreseeable future, and it is quite possible that we will never see such interest ever again. A chilling thought.

These are not issues of Shari'ah compliance, although heaven knows we may not be free from that particular briar patch yet. These are issues of asset quality and they will remain of paramount importance for years to come. Of course the issue of Shari'ah compliance is important within the Shari'ah space and here we have the twin thoughts of whether the Sukuk structure is Shari'ah compliant following Usmani's comments of some years ago and the subsequent clarifications from AAOIFI, and the unfortunate smokescreen that billowed through the industry following the BLOM/Investment Dar debacle which helped no one other than a handful of lawyers and dealt a serious credibility blow to the entire industry.

I would ask any reader to imagine for a moment that they were of the asset managers charged with investing CalPERS' money. Would you invest any of those funds in a Middle East Sukuk? Presuming that the instrument had a rating, would you believe that the rating was a guide to asset quality or a guide to the likely willingness of the issuer to repay the debt in full and on time? And here is the dilemma which is a fundamental problem of trust and expectations. Many investors who happily scrabbled for an allocation from every pre-financial crisis Sukuk now will not invest at all and it is not likely that they will return to the party any time soon.

Can we learn anything from Malaysia?

The answer to this, sadly, may be 'no'. Most Malaysian issues are ringgit denominated and therefore the bulk of the audience for them is domestic. The GCC, broadly speaking, wants to tap foreign investment (with the probable exception of Saudi Arabia) and is more interested in securing diversity of funding rather than in building a domestic debt capital market. There are so many differences between the two markets that the only realistic lesson from Malaysia to the Gulf would be to go back to first principles and try to build a comprehensive and well-regulated debt capital market that was truly pan-GCC and had the buy-in from all the relevant central banks. Get away from the Ad Hoc-ery of the past and try to develop a meaningful market with real depth that has international credibility and appeal.

It is all too easy to gloss over the failure of the (tiny) Thomas Cook Sukuk as a red herring. The reality is that the $50 million instrument was probably too small to begin with and hardly justified the amount of work, not to mention legal fees that must have gone into it. So why then are we trumpeting the success of the UK's first Sukuk from International Innovative Technologies that clocked in at a mere $10 million? Look at the small print: Dubai-based Millennium Private Equity will be the sole investor in the Sukuk, which will be listed on the Cayman Islands Stock Exchange and which will pay 10 per cent a year. Ten per cent is 10 per cent in anyone's book.

Is the crisis in the Sukuk market likely to afflict the rest of the Islamic finance space?

My very real worry is that it will. I have been actively involved in the Islamic finance space since 2002 when I launched Islamic Finance Weekly from London and I have been speaking to leading practitioners within the industry on a regular basis since then. Never before have I heard so much negativity and doomsday stuff as I hear at present. In larger part there is a hope (which I share) that things might pick up and look more promising after the end of the holy month of Ramadan and Eid.

But I feel sure that the Islamic finance industry will only pick up after the global economy picks up and leading pundits suggest that this might not happen for another two years and that we might be in for another serious downturn before then. What chance does a tiny little budding industry have when the wheels continue to come off the whole world economy?

Some readers might remember a time when the hedge fund industry was flavour of the month and then it all came crashing down in a spectacular collapse. That was many years ago and still the hedge fund industry has not fully recovered. The private equity industry met a similar fate not so long ago. And now it is the turn of Islamic finance. We need to ask ourselves whether the industry can only grow and prosper during the good times or whether it can reach a stage of maturity so that it can stand on its own two feet even if the rest of the global economy is going through a downturn. Surely if what we say about risk aversion being a core part of the Islamic finance industry is true that this cannot be such an idle pipe dream?

Do not misinterpret this as a call for the Islamic finance industry to be disconnected from the rest of the financial world: far from it. What I think we should be looking for is an industry that leads from the front and shows the rest of the industry the way out of the recession. How do we do this? By being different and by sticking to the teachings of the Qu’ran and by standing above the grime and quick fixes and doing things ethically. What we started out to do in the first place, in other words.

But in order to get better we have to admit the mistakes of the past and learn from them. And pretending that the industry is 'headed towards $2 trillion dollars in the next few years' helps no one. It is the same kind of wrong-headed rubbish that got us into this place in the first place. Let us be honest and decent and learn from our mistakes and build a stronger, if smaller, industry.

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Blake Goud

Portland, USA

How do we fix the current crisis in the Sukuk market? Issuance has virtually dried up in the GCC – is this fixable? Are there lessons to be learned from Asia? Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

The Sukuk market remains trapped by the financial recession and - notably in the GCC - has been stagnant following the Dubai debt crisis that began in late 2009. However, the scene is not uniformly bad; issuance in Malaysia and other parts of Asia has rebounded from the financial crisis to a much greater degree than the GCC. The primary reason - in my opinion - is that the market activity leading up to the financial crisis in the GCC did not have time to become as mature as in Asia and there was a greater reliance on certain sectors - notably real estate - which was hit the hardest in the financial crisis. Estimates place the fall in real estate prices in Dubai as an extreme case at 50 per cent from pre-crisis highs.

This divergence in performance of Islamic finance between the GCC and Asia also reflects the investor interest from outside of those regions, which helps finance the Sukuk issuance. Global investors have flocked to Asia in the wake of the financial crisis, in conventional as well as Islamic spheres. For example, of the top five ETFs tracking single country indices (measured by current year performance), three - Thailand, Malaysia and Indonesia - are in Asia and both Malaysia and Indonesia have been aggressively developing their Islamic finance industries. In contrast, the Bloomberg GCC 200 Index is roughly flat for the year.

The poor stock index performance in the GCC and low level of Sukuk issuance for the year contrasted with outperformance of stock markets in the countries in Asia where Sukuk issuance is booming suggests that economics is likely having more of an impact in the GCC than anything specific to the Islamic finance industry. It would not surprise me to see issuance from the GCC - particularly the corporate sector - to remain constrained for a while and be out of sync with issuance from Malaysia and Indonesia.

However, I do not see the weakness in Sukuk issuance in the GCC as a result of anything specific to the Sukuk market. And the GCC should recover - most of all in investor confidence - which will lead to a rebound in the number of Sukuk issued based on increases in oil and natural gas prices. However, it is likely that the types of projects financed by Sukuk, as well as their geographical distribution, will be different than pre-crisis. There will, one hopes, be greater focus on infrastructure projects and a lesser focus on real estate - particularly luxury real estate - which was significantly overbuilt in places like Dubai. The geographical focus will likely shift from the United Arab Emirates to Saudi Arabia and Qatar and the activity within the UAE will likely move away from Dubai and towards Abu Dhabi.

There is one area that I see hampering Islamic finance when confidence returns to the GCC and new bond and Sukuk issuances begin to return: it is more expensive for issuers to issue a Sukuk than it is a conventional bond and there is not much - beyond Shari'ah compliance - that differentiates a Sukuk from a bond to compensate for that added cost. When yields are higher because of economic uncertainty issuers may be more hesitant to pay the additional costs associated with Sukuk and unless these costs come down or there is a compelling reason why a Sukuk is preferable, I think it will limit the number of new Sukuk being issued for the next couple years.

That being said, I think that there remains a natural demand among many wholly-Islamic financial institutions for Sukuk that could offset the additional costs. Many financial institutions in the GCC have a mandate that limits their investment universe to Shari'ah compliant investments and many of those are likely to be looking for fixed income products. And I believe there may be new developments that make a Sukuk attractive in environments where the economy is recovering but yields overall remain low.

The best example of this is the Sukuk ALIM program that was jointly developed by Cagamas and Al Rajhi Bank. The Sukuk resemble the Sukuk al-istithmar Sukuk issued by the Islamic Development Bank with one significant difference: the redemption price is determined by an auction. At maturity, the underlying assets of the Sukuk are sold via auction with a minimum (reserve) price equal to the principal and final periodic payment. If no outside buyer makes a higher offer, the issuer is able (but not obligated) to offer the minimum bid to redeem the Sukuk at par. However, because the assets can be auctioned for a higher price, it provides investors with potential for upside gain, while limiting their risk because of the reputational damage if the issuer were not to make a minimum bid for the assets.

That is not to say that they share the exact same risk-reward profile as a conventional bond. There is always higher risk associated with higher return and the way that the Sukuk ALIM are structured, the investor could presumably take possession of the assets in lieu of repayment (by making their own bid for redemption at par).

Islamic finance - and specifically Sukuk - has been significantly impacted by the global financial crisis and the recession which has followed. This divergence has been accentuated by the different economies of the GCC and Asia, which should create less worry that somehow the structure of Islamic finance and Sukuk suffered lasting damage as a result of the crisis. However, even as Sukuk issuance in Asia picks up, there will be a much slower level of growth in the GCC. It would be helpful if new developments like the Sukuk ALIM - which does not entirely replicate the conventional bond - became more widely used.

So Far

David Vicary (Daud Abdullah)

Kuala Lumpur, Malaysia

How do we fix the current crisis in the Sukuk market? Issuance has virtually dried up in the GCC – is this fixable? Are there lessons to be learned from Asia? Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

To a large extent this is a reflection of confidence. Confidence took a battering during the crisis. People's knowledge of how they thought Sukuk worked was exposed and many people realized that what they were actually holding was not what they thought they were holding. I think that a time for reflection on where we have come from and where we are is always good for future growth and I have a strong sense that that is where we are now with Sukuk.

I have a feeling that there is pent up demand, but investors are not quite convinced that the time is right and all the outstanding issues have been settled. Some conformity amongst the Shari'ah supervisory boards is needed. Standardisation of certain contracts and structures is necessary in order to avoid inconsistencies between different Fatwa rulings and their application by Islamic financial institutions regionally and globally. Why is a global standard for Sukuk essential?

- Well, for one thing, the absence of standardisation could well be contributing to the current low issuance levels in the GCC.

- In addition, the Global financial crisis has raised a number of structural issues in Sukuk such as transfer of ownership and the Sukuk holder's right and ability to have direct control over the assets in the case of a default.

- There is an urgent need to revisit the issue of asset based versus asset backed Ijarah Sukuk

There could be a call for the establishment of a Shari'ah board at a global level, which would undoubtedly help. Such convergence and harmonisation can only occur with greater engagement among regulators, practitioners, Shari'ah scholars and other stakeholders in the Islamic finance industry. While there are some encouraging signs, I am afraid that this process may take a very long time and it may only be a downturn in the IF growth rates which stimulates the need for urgent change!

Issuance has virtually dried up in the GCC – is this fixable?

The short answer is absolutely, yes. However, the challenges outlined in the section above will need to be addressed. There appear be some changes afoot in the GCC regarding Shari'ah board composition and a move toward more country and regional specific Shari'ah boards. This may well help in the rapid spread of standardisation.

Are there lessons to be learned from Asia?

Well Sukuk is certainly back in play in Asia. I also sense that the same doubts that exist in the GCC market have not been so apparent in Asia. This may be a case of familiarity and volume. For some years now the majority of capital raised in the Malaysian market has been done on a Shari'ah compliant basis. I think some of the main questions raised above still exist, but with National Shari'ah Councils and research undertaken by ISRA, much helpful work has been done to reassure investors that Sukuk are still OK. It is anticipated that in Malaysia, at least, Sukuk issuance levels will be up to pre-crisis levels by the end of 2010.

Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

I do not believe it will. I am already starting to see some improvements in confidence and I am sure that Sukuk will bounce back all the stronger. However, we should never be complacent. Maybe we got a little ahead of ourselves and the fallout from the crisis has given us a good opportunity to review and reflect and give ourselves a chance to move forward towards the next level.

As always there is much to do and not a moment to lose.

So Far

John Sandwick

Geneva, Switzerland

How do we fix the current crisis in the Sukuk market? Issuance has virtually dried up in the GCC – is this fixable? Are there lessons to be learned from Asia? Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

Many bankers observed with concern the failure to date of the year 2010 producing any breakout new Sukuk issuances. Most market participants are anxious to put the past behind them. Since the suggestion of Nakheel defaults of late 2009, and some very tough times for many other Sukuk backed directly or indirectly by real estate, the market has been waiting for a breath of new life from a signature new issue that would herald the beginning of a new era in Islamic finance.

Clearly the $500 million G.E. Capital Sukuk of November 2009 should have pushed the market forward. It was, after all, the first true international corporate Sukuk, a milestone in the industry. But it was so closely followed by the threats of mega defaults in Dubai and lesser ones in Kuwait that the wind was quickly taken out of the sails of the new issue market.

Of course the immediate past collapse of global market valuations, the impact on investor and issuer psychology from the global financial crisis, and general uncertainty have all played an important role in undermining confidence in new Sukuk issuance. And, those are the global contributors. Imagine the role of local factors, such as Gulf Finance House's woes, the dramatic collapse of revenue at

Arcapita, and the near disappearance of the region's private equity industry. Combined, there were plenty of logical reasons for new Sukuk issuance to come to a standstill. Both internationally and regionally we can understand why CFOs and treasurers were saying no to new Islamic bonds.

Yet despite this compelling story there is more than meets the eye. One has to look behind the scenes and dig a little deeper. Most of what follows is anecdotal, not hard news. But the results are clear enough.

In April and through early May 2010 the Golden Age Sukuk was shown to over 90 Islamic treasuries, mostly in Saudi Arabia and the Gulf but also as far away as Geneva, London and Kuala Lumpur. These Sukuk were created to purchase and then lease-back aircraft for the Thomas Cook Group, a 150-year-old British stalwart in the travel industry. Golden Age would have been Europe's first corporate Sukuk, another milestone in the industry.

For the first month of distribution the issue's lead manager, Wasatah Capital in Riyadh, insisted on a 7 per cent coupon and a highly restricted distribution policy to only Saudi buyers, strict conditions that were not relaxed until it was too late. Despite a parallel Thomas Cook issue of over $1 billion in 5- and 7-year bonds at very advantageous rates on the London Stock Exchange, Wasatah was unable to sell enough of the Golden Age Sukuk to achieve a closing. The Sukuk were withdrawn from the market.

This story is illustrative of failures in the Sukuk market, not on demand but on the supply side. In the case of the Golden Age Sukuk, the lead manager simply misjudged the market by a wide margin. What could have been a very successful new issue, making global headline news, was instead a distinct failure.

Importantly, the more than 90 Islamic treasuries that saw Golden Age could be divided into two camps. About half were mired in restructuring and workout situations with their own asset books, which were heavily invested in real estate, primarily within the Gulf region. As is well known collapsing real estate valuations in most GCC markets put enormous strains on treasuries, and Islamic banks no less than conventional ones. This half of the market could not bear any new issue purchases, as they simply did not have the liquidity to buy any new asset.

However, it is the other half of the market that is most interesting. Thankfully, many Islamic treasuries were prudent throughout the boom, carefully limiting their exposure to high-risk real estate developments. For the most part these treasuries were flush with cash.

And, importantly, they were and still are hungry for new Shari'ah compliant fixed-income securities. They have an average "sweet spot" for 3- to 5-year Sukuk that bear the highest yields possible for low-investment-grade ratings. They especially love a global blue chip corporate name not involved in real estate, since such issues are essentially nonexistent except for the G.E. Capital issue.

In fact, a vast pool of liquidity was readily available for the Golden Age Sukuk. The Sukuk would have very likely been oversubscribed had they been issued at market terms, so great is the apparent demand for new Islamic bonds.

Regrettably, the miscalculation of market conditions doomed the transaction. The market was seeking at least an 8.5 per cent yield to compensate for the deal's small size and the lack of a listing, rather than the 7 per cent being offered. And, the true market for Golden Age Sukuk was not at all in Saudi Arabia, but in the banks around the Gulf region, in Europe and further abroad. Late understanding of these market dynamics led to the failure of the Sukuk.

Why is this important? Because the Golden Age Sukuk could have been the first of many. Outside Saudi Arabia and the Gulf there are literally hundreds if not thousands of potential Sukuk issuers. They will not issue Sukuk until they see someone else go first. Think of the nearly Euro 1 trillion in new financing required by European corporations and governments in the coming 24 months, then draw a line to those that have abundant long-term fixed assets, and you will quickly see the potential for European Sukuk.

Treasurers and CFOs everywhere are in a constant scramble for new, diversified sources of funds. Just as Ford Motor issues bonds in Tokyo, Frankfurt and New York, so do most multinational corporations and many governments. For them a rich, reliable market for their Sukuk would be highly useful tool in their fundraising arsenal.

The demonstration effect is powerful. The G.E. Capital Sukuk's impact was limited by nearly immediate late-autumn negative news on Nakheel. Most issuers initially avoided the market. But by the early spring of 2010 the tides were beginning to turn. Dar Al Arkan's $400 million Sukuk showed demand was sufficiently strong. A blue chip brand like Thomas Cook was just what was needed to revitalize an otherwise moribund market, and its timing in the market was nearly perfect.

This makes the failure in issuing the Golden Age Sukuk even more troubling and the inability to provide market terms for the Sukuk was not just a loss for the dozens of professionals who spent inordinate amounts of time and energy preparing a world-class Sukuk; it was a loss for the greater Sukuk market itself.

Since the Golden Age Sukuk were pulled from the market we have witnessed the great negative credit events of June and July 2010, the most visible being the near collapse of Greek national bonds. Yet slowly the markets are returning, and hopefully in time to capture the attention of corporate and municipal issuers in Europe and elsewhere.

Many Islamic treasuries still have enormous demand for high-quality securities, but almost no supply. Until more Sukuk issuers come to the plate with correctly priced deals, we will not go back to the good old days. European corporations and municipal borrowers in line to access the Eurobond market could easily also tap the Sukuk market. When they recognize the potential in diversifying their funding with a very reliable new source of capital, they may start a trend toward European and eventually global Sukuk issuance.

So Far

Penumbra

pe·num·bra (pĭ-nŭmˈbrə)

1. A partial shadow between regions of complete shadow and complete illumination

2. An area in which something exists to a lesser or uncertain degree

The following are some comments on the third issue of So Far (the search for excellence in Islamic finance issue) – download a copy from [here.]()

‘I thought the third issue was great but I don’t think anything will change. Like soccer clubs, the clubs with the most money will still buy the best players and Islamic banks with the most money will still buy awards’ – ***Banker, Saudi Arabia***

So Far

‘I dearly wish people would take Daud Abdullah’s advice and ‘just say no’’. ***Treasurer, Qatar***

So Far

‘More issues like number 3, please’ ***Mature student, Bahrain***

So Far

‘Not every bank that wins an award pays for it, you know. There are some real awards out there and I think we all know the good from the bad.’ ***Islamic banker, London***

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