Global Islamic Economy Summit Series

WEBINAR 4

The opportunities and challenges in the Sukuk market

Whitepaper

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After a slow spell in the mid-2010s, the sukuk market has grown significantly in the last few years.

2019 was a year of record issuances, with over $162 billion of sukuk being issued (31% higher than 2018), and the overall sukuk outstanding reaching $524 billion, the first time that the sukuk industry has crossed the half a trillion-dollar mark. The rise was driven by growing sovereign issuances in the GCC, Malaysia and Indonesia, significant growth in corporate issuances (which grew by 34% in 2019) and the increasing popularity of short-term issuances and new instruments such as green sukuk.

Trends in 2020 were disrupted by both the Covid-related disruption as well as turmoil in commodity markets. The spread of the novel coronavirus brought economic activity to a halt worldwide in March and April. As some countries brought the first wave under control, and some economic activity resumed, so did sukuk issuances. Most of the issuance since then have come from sovereign issuers financing their Covid relief packages to support businesses and individuals.

As we look towards the new normal that will be in place after the Covid-19 pandemic has been addressed, we can already see the growing significance of ESG and SDG considerations on capital markets. This is expected to continue to drive the development of new sukuk instruments, such as issuances of green and SDG sukuk in Malaysia, the issuance of green sovereign sukuk by Indonesia, green corporate sukuk by UAE based Majid Al Futtaim, and the recent Euro-denominated green sukuk and dollar-denominated sustainability sukuk issued by the Islamic Development Bank.

WEBINAR DISCUSSION

SUMMARY POINTS

- In terms of the volume of sukuk issuance at the end of August 2020, it was down 17 percent compared to the same period last year, but interestingly, the volume of issuance for foreign currency was up by 12 percent. This was primarily driven by banks, multilaterals, and to a lesser extent sovereign issuance.
- Despite the growth in the market and the tremendous advancements of the Islamic finance industry over the last 20 years, there are worrying signs. For instance, the compound annual growth rate has considerably fallen over the last 10 years, fluctuating between 8-10 percent versus a much longer period, when it was double that at 25 percent.
- Sovereigns and banks currently represent 80 percent of current sukuk issuance, which is too concentrated. The industry needs to see new types of investors in the market, such as asset managers, fund managers, pension funds, and insurance companies.
- Even in the wake of Covid-19, the sukuk market is unlikely to see a pickup in default rates because most companies and sovereigns in the global sukuk market are high quality, and most banks are in good shape.
- While there was recently a liquidity shock in the credit market as well as an oil price shock, the extent of the drawdown seen in the sukuk market was significantly lower than what was seen on the conventional side.
- There is a strong need for inclusive standardization to make the sukuk issuance process less complicated and less costly. It is no longer about standardization of the structure and legal document; it's about inclusive standardization that takes into consideration the requirements of all the issuers, scholars and investors.
- Potential accelerators for the global sukuk market include streamlining the process of issuance using standard legal documents, leveraging fintech, establishing a local currency program similar to that of Saudi Arabia, as well as the alignment of Islamic finance with ESG metrics.
- Data is not available for a lot of the sovereigns and corporates, and it makes things more difficult and expensive. With the absence of data, companies need to make assumptions and forecasts, and inherently they are going to err on the side of caution, which means they are going to want more in terms of return. The current data gaps are also going to inhibit the industry's ability to attract ESG-related investments and keep its sources of funding competitive.
- To open the sukuk market to retail investors, lower denominations need to be offered and this will come mostly through local currency markets. Some fintech companies are already working on solutions to lower the denomination threshold for retail investors to $1,000 per sukuk.

As 2020 began, the Islamic finance industry was expecting the volume of global sukuk issuance to be around the figures of 2019, around $162 billion, but the Covid-19 pandemic and oil prices decided otherwise.

Consequently, S&P Global Ratings revised their forecasts to a sharp decline in the volume of issuance and put the overall expectation at around $100 billion for 2020. Since then, the credit rating agency has observed central banks in the region and globally opening the liquidity bank widely, and more recently, these authorities made it clear that rates would be lower for a long period of time, which has created a window of opportunity for issuers to tap the market again in an aggressive way.

Dr. Mohamed Damak, Senior Director & Global Head of Islamic Finance Financial Services Research at S&P Global Ratings said: "In terms of the volume of issuance at the end of August, it was down 17 percent compared to the same period last year, but interestingly, the volume of issuance for foreign currency was up by 12 percent."

This was primarily driven by banks, multilaterals, and to a lesser extent sovereign issuance. Corporates, on the other hand, have not been issuing that much sukuk; instead, they have been holding on to cash and reducing capex, trying to navigate the uncertain environment. Even in developed markets, almost all recent sukuk issuances have been by sovereigns or supernationals that want to increase their profiles with Middle Eastern investors and diversify their resources.

Despite the noise and concern created by the pandemic, **Mohieddine Kronfol,** Chief Investment Officer of Global Sukuk and MENA Fixed Income at Franklin Templeton Investments, does not expect to see a noticeable pickup in default rates.

While there has already been had one default this year related to a healthcare company in the UAE, and there are some real estate companies that may decide to restructure, these cases have been driven more by fraud or maleficence rather than excessive amounts of leverage.

"When we think about the global sukuk landscape and the GCC bond market, which makes a big portion of the investible universe, you tend to find that companies and sovereigns are high quality, and that the banks are in very good shape, so we don't expect default numbers to be anywhere near the expectations we have in the developed world or larger emerging markets," said **Kronfol.**

Despite the growth in the market and the tremendous advancements of the Islamic finance industry over the last 20 years, there are worrying signs. For instance, the compound annual growth rate has considerably fallen over the last 10 years, fluctuating between 8-10 percent versus a much longer period, when it was double that at 25 percent.

"We find that sovereigns and banks represent 80 percent of the issuance, so it's still too concentrated. We've seen a dearth of high-quality or investment grade issuers come to market. Also, nearly half of the last 10-11 years have seen negative growth rates; we see one good year then a slightly negative year. So, we're losing a lot of momentum and we should not rest on our laurels, there's still a lot of work that needs to be done. We need governments to invigorate efforts to develop the shariah market if we want to see the industry develop and achieve the potential it can. We should collectively do more pushing to see the industry grow."

The speakers agreed that the industry needs to see new types of investors in the sukuk market, such as asset managers, fund managers, pension funds, and insurance companies.

SUKUK PERFORMANCE

When it comes to sukuk performance, the industry often evaluates this in comparison to conventional bonds. According to **Angad Rajpal,** CFA, Head of Fixed Income at Emirates NBD Asset Management, over the last year, the sukuk market in absolute terms has done equally well as conventional peers. However, in stark contrast to conventional peers, on a risk adjustment basis, the sukuk market has significantly outperformed conventional peers.

"The sukuk market has been true to its form. A great example: you had a pandemic, a liquidity shock in the credit market as well as an oil price shock, but the extent of the drawdown that we saw in the sukuk market was significantly lower than what we saw on the conventional side," explained Rajpal. Part of the reason for the good performance is structural: sukuk inherently has higher quality buyers, and the composition of the market has huge bias towards sovereigns and financial institutions - those instruments took a much lower hit.

Kronfol noted that over the last two years, the market share of sukuk in the region has stood at around 20 percent, down from 40-50 percent five years ago. This implies that the number of sovereigns and banks that are opting for sukuks has come down. Furthermore, when it comes to high yield sukuk or independent sukuk corporates, they have struggled and suffered, and they continued to lag.

"It's worth highlighting that when you move out of this sovereign financial high-quality segment, there haven't been many bids and the sukuk market had to face serious challenges like other markets. The higher yielding portion certainly struggled during the pandemic. In many perspectives, this dedicated investor base suppresses volatility but when you have a crisis, the liquidity is slower. It has a significant contribution. There are two sides to every coin," said **Kronfol.**

According to **Rajpal,** the recovery that the industry has seen since the end of March has been driven a lot by liquidity. Almost 80 percent of the flows at Emirates NBD Asset Management have been towards Islamic assets. Clearly, the industry has always had an issue with the sukuk market, with too much money and too few sukuk, but that problem has become more paramount since the Covid-19 crisis.

MOVE TOWARDS STANDARDISATION

In terms of sukuk structures, there has been a drive towards standardization in the Gulf region, partly driven by regulation. For example, the Central Bank of the UAE has become more active when it comes to regulating the Islamic finance space; regulations are now in place requiring that sukuk structures comply with the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards.

Such developments have led banks and other issuers to take a step back and look at how are their structures not complying with AAOIFI, because they need to have something that sells widely when they market to investors.

However, **Damak** stressed on the need for inclusive standardization. "If the AAOIFI standards do not take into consideration market practices, this could be detrimental for the development of the sukuk market. It's no longer about standardization of the structure and legal document; it's about inclusive standardization that takes into consideration the requirements of all the issuers, scholars and investors."

According to **Ali Taufeeq,** Director, Debt Capital Markets at HSBC Bank Middle East Limited, there has been more innovation and a move towards asset-light structures in the past five or six years and the structure space has become much more flexible. Malaysia has particularly excelled when it comes to innovation as the country is keen to retain its position as an Islamic finance hub in Asia and they have tried to innovate where they can when it comes to sukuk structures.

Taufeeq added that the market has gone through a period of innovation and is now heading towards standardisation. Moreover, sukuk issuers are in the same boat as a lot of conventional issuers in the Gulf, and there has been a bifurcation in the investment grade versus the sub-investment grade market in the region. He said that investment-grade issuers have seen spreads and yields tightened, such that the yields on offer now are in some cases lower than they were pre-pandemic. Whereas for lots of sub-investment grade, higher yielding issuers, they had to take a step back and look at alternative forms of financing, either from the bank or equity market, depending on the sector they operate in.

"They probably have a little while to go before they can dip their toes back into the sukuk market, just because yields have gone up significantly for them. There are the two factors shaping the sukuk market at the moment – the cost of funding and standardisation," said **Taufeeq.**

MARKET ACCELERATORS

S&P Global Ratings has been quite vocal about the drop in the growth rate of the Islamic finance industry over the past couple of years and has tried to identify potential accelerators.

A potential gamechanger would be streamlining the process of issuance using standard legal documents, as we are still in an environment where some of the sukuk issued in Asia is considered as non-shariah complaint in the GCC region, according to **Damak.** Fintech could be another gamechanger, and so would the establishment of a local currency program similar to that of Saudi Arabia. The kingdom started an unlimited local currency program in 2017 and today, it issues more than $20 billion of sukuk every year.

Another accelerator for the sukuk market could come from the alignment of Islamic finance with Environmental, Social, and Governance (ESG) metrics. This does not necessarily mean that all Islamic finance issuers should be perfectly aligned with ESG, but there are some intersections between Islamic finance and ESG; one of them is the green sukuk we saw being used in the region by Majid Al Futtaim, or social sukuk. These instruments could grow in the future as the market shifts towards focusing on attracting more ESG investors.

One of the challenges the industry has faced globally has been educating the market about what Islamic finance is and how companies can benefit from it. **Taufeeq** said there are many low-hanging fruits to pick; if Islamic finance and sukuk professionals made more visits to treasuries and CFOs in developed markets across Europe, the US and Asia, talked about the sukuk market and marketed it to them, this could lead to increased activity in global sukuk, and possibly more sovereigns and supernationals coming from developed markets.

SAUDI SUKUK MARKET

Saudi Arabia is an important driver for the growth sukuk market due to the capital available in the country and being a larger economy.

The kingdom established its sukuk market in 2017 and since then, the government and corporates have issued several sukuk. In the first half of 2020, Saudi sovereign issuance roughly accounted for 54 percent of total issuances out of the market, and the country's reliance on the sukuk market was about 37 percent of their total funding needs, according to **Rajpal.**

Clearly, sukuk plays a huge contribution to Saudi Arabia's budgetary needs. However, as far as progress is concerned, the issue with the lack of diversification is still pervasive as most of the Saudi sukuk issuance is sovereign. In the sukuk space, there are tenors of up to 30 years, but the country lacks a secondary market for trading these. Likewise, on the corporate side, only a handful of instruments have been issued. While the government and regulators have done lot to reduce the fees and provide incentives for issuers to come and issue sukuk, it may take some time before this becomes mainstream.

According to **Kronfol,** the lack of corporate issuers is not just a sukuk market issue. Even in the conventional bond space, corporates are not hitting at the weight they should be, considering the large number of large corporates in the region that still haven't tapped the bond or the sukuk market.

He added that several announcements have been made recently about Saudi Arabia wanting to kickstart and develop their bond market, both conventional and Islamic. One of them was about having Saudi securities being tradeable, yet it remains unclear who can buy them, and whether they need to go through the same Qualified Foreign Investor process that equity investors need to undergo.

"There is still some uncertainty around how best to do that, and this needs to be clear if we were to see the Saudi market develop. We see such a high proportion of Saudi sovereign issuance and the improvement there is that the price discovery is good. But when you look at the corporate sukuk in Saudi Arabia, there's very little price discovery that takes place, and therefore, these things tend to get placed with almost related parties and they never trade.

"The whole process doesn't lend itself to a healthy market, in that when [corporates] are placing sukuk issuances, they're either too small, mispriced, or placed with a small number of investors. Then they sit on their books for years and then they come back and ask why aren't we trading? It's because the entire process is not following the same process of when you have a normal book-building and price discovery process that you have in other parts of the region and the world," explained **Kronol.**

He added that more work needs to be done for the Saudi sukuk market to develop the way the dollar bond market has for them, and that domestic issuances should be priced in a manner that is consistent with the dollar issuances that are being placed.

INSUFFICIENT DATA

A major challenge slowing down the regional sukuk market is the lack of data. Compared to the more developed markets, data is difficult to find in the MENA region when it comes to corporates, private and family owned businesses, and even at government level. From an investor's point of view, data is crucial to help forecast where things are headed and make better-informed decisions.

"Data is not available for a lot of the sovereigns and corporates, and it makes things more difficult and ultimately more expensive. Because with the absence of data, you need to make assumptions and forecasts, and inherently you're going to err on the side of caution, which means you're going to want more in terms of return," said **Kronfol.**

One of the measures that Franklin Templeton Investments took was to send questionnaires and ask issuers what they were doing in terms of different ESG risks and how they could collaborate with each other. Out of 140 questionnaires that were sent out, the company received only 12 back.

"This is just to give you a sense of the companies and people that are interested in pursuing this dialogue. The data gaps are at the sovereign level, and this will inhibit our ability to attract ESG-related investments and keep our sources of funding competitive. In the absence of those, it makes the longer-term plans for the region to diversify and develop its markets more difficult. We are here to try to raise awareness so we can address these challenges and minimise those costs going forward," said **Kronfol.**

ESG AND SUSTAINABILITY

Speaking about ESG metrics and sustainability, the industry has seen several issuances of green sovereign sukuks by Indonesia and green corporate sukuk by UAE-based Majid Al Futtaim, as well as the recent Euro-denominated green sukuk and dollar-denominated sustainability sukuk issued by the Islamic Development Bank. In Malaysia, there have been issuances of green and SDG sukuk under the Sustainable & Responsible Investment sukuk framework.

According to **Kronfol,** there is a good opportunity for Islamic finance to attach itself to the growth of ESGs, because there are overlaps and it would be useful for the industry, which scores highly on a number of ESG metrics. However, some people take this association for granted and assume that because Islamic finance has different ethical criteria, they would score highly on ESG metrics. However, in reality, that is not the case. In the sukuk universe, for example, not many sovereigns score highly compared to those in more developed markets.

"There is a potential journey to go on to be able to improve these metrics, make the sukuk market more mainstream and tap into this important and growing demand base. It's a great opportunity to capture but we shouldn't take it for granted. We need to be working hard as sovereigns, issuers and market participants to make the sukuk market is a highly rated ESG-investment universe," said **Kronfol.**

Taufeeq highlighted that the sukuk market in the MENA region has lagged what issuers have done in Europe and Asia. In France for example, the government has made it in mandatory for investors to provide disclosure on how much of their investments are in ESG instruments. That has driven the market a lot in terms of interest and new issuances in Europe.

In the MENA region, the first few issuers have come to the market and more are expected to come this year. The continued progress of this market requires some work. Using the proceeds for green or social purposes is not enough; the overall ethos of companies needs to shift to a more green or socially conscious landscape.

WHAT BLOCKCHAIN CAN SOLVE

Moving to the topic of blockchain, **Damak** said that it can solve three problems that the sukuk market faces today. The first is the flexibility of the underlying assets. When an issuer starts a sukuk, they have certain underlying assets that could be substituted during the lifetime of the transaction, and the risk profile of their transaction could change completely, but the investor would not know. With blockchain, each time an asset is taken out and a new asset is put in, this would be documented.

The second challenge that blockchain could solve is the traceability of the assets, according to **Damak.** This would be helpful for sukuk where there are a multitude of underlying assets, enabling issuers to implement proactive actions promptly when they are needed and providing them with upfront information each time an asset is not performing up to expectations.

The third issue that blockchain could help with is with regards to the traceability of investors. Here, it would allow a swift resolution of problems when sukuk would need to be restructured, for example, and when there is a need to go back to who is holding the sukuk. Today, the process is done manually while with blockchain, there would have a ledger showing on a real-time basis who is holding what.

According to **Damak,** there have been a few interesting experiences of using blockchain in the sukuk space. For instance, a company that launched in Dubai International Financial Centre last year created a platform for issuing sukuk, using standard legal documents and blockchain. If this model were to be adopted by the market, it could offer some growth opportunities, especially for small or mid-size corporates that are looking at the sukuk market but cannot get in because of the costs or complexity.

RETAIL INVESTORS

On the issue of including retail investors in the sukuk market and whether Islamic Exchange-Traded Funds (ETF) could be a good access point, **Taufeeq** said that one of the problems is the high cost of sukuk certificates, which are priced at around $200,000. These sukuk are usually targeted at institutional and wholesale investors.

To open up the sukuk market for retail investors, lower denominations need to be offered and this will come mostly through local currency markets. Some fintech companies are already working on solutions to lower the denomination threshold for retail investors to $1,000 per sukuk.

Meanwhile, **Kronfol** cautioned against encouraging issuers to access retail investors directly. "As professional investors we already have issues around governance and being able to do research and detect fraud. Every year, we have two to three examples of some sort of maleficence that we have to deal with. To make sukuk issuers directly access the retail audience with the current regulatory environment and supervisory setup would be premature and may end up doing more harm than good."

OUTLOOK AND EXPECTATIONS

Looking ahead, **Damak** expects the volume of issuance to be lower than it was in 2019. In 2021, the industry could potentially see an acceleration, assuming that Islamic finance economies and companies recover as expected and more corporate issuers start to return to the market. He expects market conditions to remain supportive and liquidity to be available as central banks have made it clear that liquidity will remain abundant.

Taufeeq noted that the foreign currency market is already well established, and he expects to see more growth in local currency markets. At the same time, there is a strong need to provide more platforms for retail investors to invest in shariah-instruments, which is starting at a sovereign level.

In Kuwait, the local currency market could see some impetus if it comes from the government or central bank, and countries such as Oman, Turkey and Pakistan can do much more to promote their local currency market as Saudi Arabia has done. The Saudi local currency market, especially the government market, was almost non-existent four years ago and then suddenly, the country shifted towards promoting it. They made it easier for retail investors to invest, with a minimum amount of 1,000 riyals, and it is all listed on Tadawul, the local stock exchange.

While nearly 80 percent of investor volume in the sukuk market comes from banks, **Taufeeq** said he was optimistic that corporate sukuk issuance was going to increase in the next couple of years as the cost of funding has come down and many companies are sitting up and taking notice as they try to diversify away from the bank market.

Rajpal remarked that 2020 was a year of many firsts, including a corporate sukuk issuance from DP World, something we haven't seen since 2013. However, despite very attractive yields, the industry hadn't seen long-term issuance in a long time, so it was encouraging to see Indonesia come through with a 30-year tenor.

In his conclusion, **Kronfol** expressed excitement over the future of the sukuk market, saying that since the Covid-19 crisis, returns have been up almost seven percent, and drawdown was less than 30 percent. "The sukuk market has seen good performance and it continues to reinforce its defensive characteristics. Investors are going to continue investing in this space and as they do, this will provide issuers the incentive to tap into this demand."

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