

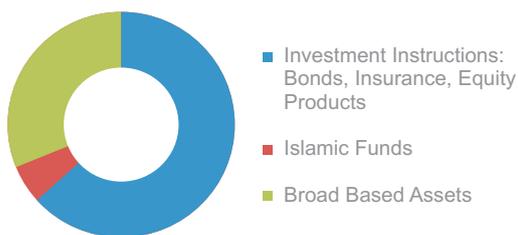
Sukuk and its Growth across Major Islamic Financial Markets

Thought Paper

Sukuk and its growth across major Islamic financial markets

Islamic banking has come a long way from its initial focal point of 'interest free banking'. Today it has a diverse range of financial products flourishing throughout the Middle East, Europe and Asia, with assets of approximately US\$1.2 trillion as of 2010. The industry is expected to grow at an annual rate of 25 percent.

By the end of 2010, 63.4 per cent of the \$1.2trn was held in Islamic instruments such as Shariah - compliant bonds (Sukuk), insurance (Takaful) and equity products; 31.1 percent in broader-based assets (mainly in Shariah - compliant bank accounts and money-market vehicles) the rest was held in - dedicated Islamic funds.



World Islamic Assets Distribution: 2010

Source: CIMA FM Magazine

It has been observed and widely debated that Islamic banks fared better than their conventional counterparts during the economic downturn. An IMF paper analyzing this says "Factors related to Islamic banks' business model helped contain the adverse impact on profitability in 2008. In particular, adherence to Shariah principles precluded Islamic banks from financing or investing in the kind of instruments that have adversely affected their conventional competitors and triggered the global financial crisis." This has led market players to look at the importance of Islamic banking. However even though the result of the debates remain uncertain there is no ignoring the burgeoning investor base, both from Islamic and non-Islamic backgrounds; about 80 percent of Shariah compliant investment products in Malaysia are held by non-Muslims.

Looking at the growth expectations of this industry and growing investor base, this paper discusses one of the most popular instruments – Sukuk (Bonds), which forms a major part of investment instruments of Islamic finance, and chart its growth in markets worldwide.

Sukuk

One of the most popular instruments under Islamic finance, Sukuk's issuance accounted for 10% of the global Islamic finance industry in 2010. Sukuk are securities which comply with Shariah principles: (i) prohibition of payment and acceptance of interest and (ii) investment in activities which are speculative, uncertain or unjust.

Though widely known as 'Islamic Bonds' they are different from conventional bonds on various counts. Sukuk represents an undivided ownership in the underlying asset and partnership in the risk-returns of the underlying business. Sukuk is asset based; in many cases its structure mandates

minimum percentage of tangible underlying assets. Unlike bondholders Sukuk certificate holders do not have a guarantee on their returns. Also, since Sukuk can only be issued for a purpose allowed under Shariah law, there is an inherent risk of the issue being declared non-complaint as there are varying interpretations of Shariah laws by Sukuk boards depending upon the county of issuance.

From an issuers' perspective, Sukuk can potentially be a cheaper source of financing. There is a lot of investible surplus in the Islamic World which is not being put to productive use due to the

lack of Shariah compliant investment vehicles. Supply is falling short of demand even with record issuance (47.1 billion H1'11), as a result of which Sukuk yields are very low as compared with conventional bonds.

Popular structures

Sukuk can be structured into various types based on different Islamic modes of financing. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which

issues standards on accounting, auditing, governance, ethics, and Shariah compliance has laid down 14 different types of Sukuk, the following are most common; Mudarabah Sukuk (partnership / finance trusteeship), Musharaka Sukuk (joint venture), Ijara Sukuk (leasing), Murabaha Sukuk (purchase order), Salam Sukuk (deferred commodity delivery), Istisna Sukuk (manufacturing or project finance) or a hybrid of the above.

Sukuk market worldwide

The first global issuance of Sukuk occurred with the Malaysian Government Sovereign Sukuk in late 2001. Global Sukuk issuance market has grown from USD 600 million in 2001 to USD 50.5 billion in 2010 and 47.1 billion already in the first half of 2011.

Country-wise breakdown of total global sukuk issuance by volume

Country	Number of Issues	Volume (US \$ Million)	% of Total Value
Malaysia	1592	115393.76	58.51%
UAE	41	32201	16.33%
Saudi Arabia	22	15351.88	7.78%
Sudan	22	13057.713	6.62%
Bahrain	125	6291.69	3.19%
Indonesia	70	4658.5	2.36%
Pakistan	35	3447.207	1.75%
Qatar	6	2500.79	1.27%
Kuwait	9	1575	0.80%
Brunei Darussalam	21	1175.91	0.60%
USA	3	767	0.39%
UK	2	271	0.14%
Singapore	5	191.96	0.10%
Germany	1	123	0.06%
Turkey	1	100	0.05%
Japan	1	100	0.05%
Gambia	7	2.086	0.00%
Grand Total	1963	197208.496	100.00%

Source: IIFM: The International Islamic Financial Market's Organization

Sovereign, Quasi Sovereign & Corporate Issue (All currency issues), Period 1st Jan 2001 – 31st Dec 2010

Southeast asia

This region continues to hold its principal position in the market with Malaysia leading the way in Sukuk and equity products. In H2'10, Malaysia's issuances constituted most of the global Sukuk market with total value of USD 23.5 billion, dominating 99% of the periods issuance in Southeast Asia and 83% of H2'10 issuances worldwide. This is a direct result of government's support towards making Malaysia an Islamic economic hub and the premier Islamic capital market. Indonesia is looking at issuing USD 1 billion Sukuk in H1' 11, this is as part of its plan to boost country's Shariah complaint finance industry.

Gulf coast countries

Due to the lack of large value Sukuk issuance, there has been a decline in sukuk market in GCC, but it still holds the second position with total issuances of value reaching USD 1.76 billion in H2'10.

Despite the decline, efforts are being made to boost the Islamic bond and equity funds business, the - Central Bank of Bahrain has introduced a new regulatory framework allowing a wider range of investment activities, including hedge funds, derivatives and

alternative investment vehicles. Dubai has also been making itself more attractive to foreign users of Shariah-compliant instruments by setting standards and signing agreements for information-sharing and assistance between regulators, as set out by the International Organization of Securities Commissions.

The vast difference between success of Sukuk in Malaysia and other Arab countries is attributed to the differences in the interpretation of Shariah Laws by Sukuk Boards in these countries. For example, in Saudi Arabia, which follows the Wahhabi form of Islam, the interpretation of Shariah is strict. Meanwhile, the highly flexible reading of the laws in Malaysia, under the Shafi school of Sunni Islam, has helped to create the world's largest Islamic bond market. The Gulf States generally chart a middle course between these two extremes.

Europe

In Europe, there has been no significant government, or quasi-government Sukuk issue, since the German Sukuk in 2004. Reportedly, the UK government scrapped plans for a sovereign Sukuk as it deemed that an issue would not represent "value for money". Though

Luxembourg also remains uncertain it is well poised for this market as no laws or amendments are needed for Shariah-compliant funds to set up here; they are not charged any taxes; and the procedural timeframe is very competitive as compared to GCC. France again is believed to be a good bet but faces political obstacles.

Cost impact

Apart from political or infrastructural impediments start-up costs – Shariah boards, extra auditing fees and regulations – is a deterrent to new entrants. But governments across all regions are devising ways to develop both the primary and secondary markets in Sukuk. More sovereign issuances would help build yield curves for more efficient pricing. Governments are also looking at tax deductions to give a fillip to the Islamic bonds sector.

Ultimately, for regions to succeed in this market it would be required that they capitalize on existing infrastructure and continuously evolve in terms of new regulations, harmonization on Shariah interpretation, liquidity management and investment in technology to reduce costs and improve distribution networks to be able to reach a wider investor base.

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