FROM EAST TO WEST

THE ORIGINS OF SUKUK MAY LIE IN THE ISLAMIC WORLD, BUT THE REACH OF THESE FUNDING INSTRUMENTS IS INCREASINGLY BECOMING GLOBAL. FAWAZ ABU SNEINEH EXPLAINS

On 25 June 2014, the UK government successfully priced its debut £200m, five-year, Regulation S sukuk. Following a series of investor meetings in Malaysia, Qatar, Saudi Arabia, the United Arab Emirates (UAE) and the UK, the sukuk offering was approximately 11.5 times oversubscribed and priced flat to the 1.75% July 2019 conventional gilt.

This ground-breaking transaction, being the first-ever sovereign sukuk outside the Islamic world, as well as the first-ever, public sterling-denominated sukuk issuance, not only marks the growing market share and demand for this sharia-compliant instrument, but it also highlights the recent trend that sukuk issuances are expanding internationally beyond the Islamic world.

The West is not completely new to issuing international sukuk. In 2009, US financial services firm GE Capital and the International Finance Corporation both issued US-dollar sukuk. Sukuk issuances have benefited issuers greatly in terms of offering investor diversification. They allow issuers to tap liquidity from Islamic institutional investors, such as Islamic banks and Islamic-dedicated funds, mainly in the Middle East, as well as from Islamic investors in the UK and Malaysia. Furthermore, sukuk issues have generally been priced close to the conventional curve for the same issuer and, in selective cases, pricing has actually come in relatively tighter than the comparable conventional bonds for the same issuer.

Historically, Malaysia was the pioneer in Islamic capital markets and it remains the world's largest global sukuk market (including domestic issues), with a share of more than 43% in the first half of 2014. But the Gulf Cooperation Council (GCC) has taken the leadership over international sukuk. The UAE ranks highest in international sukuk issuances, with a stellar 43% market share, followed by Saudi Arabia with 21%, compared to only 7% for Malaysia.

Additionally, over the past few years, a new entrant, Turkey, is gaining momentum in the market, with volumes climbing to $2.2bn in 2013, up from $350m in 2011. In 2014, we saw notable international sukuk issues from Turkish financial institutions, with Albaraka Türk, Kuveyt Türk and Türkiye Finans tapping the market, allowing Turkey to take 21% of the market share by number of issuances, in line with Saudi Arabia. In 2013, Bank Asya, the largest participation bank in Turkey, successfully issued the first-ever, fixed-profit-rate, subordinated, tier 2, US-dollar sukuk transaction, which falls due in 2023.

While the tapering of quantitative easing in the US remains the main factor affecting the global debt capital markets, Islamic bond issues stood at a record half-year high. Approximately $10bn was raised during the first half of 2014, representing 36% growth since 2012.

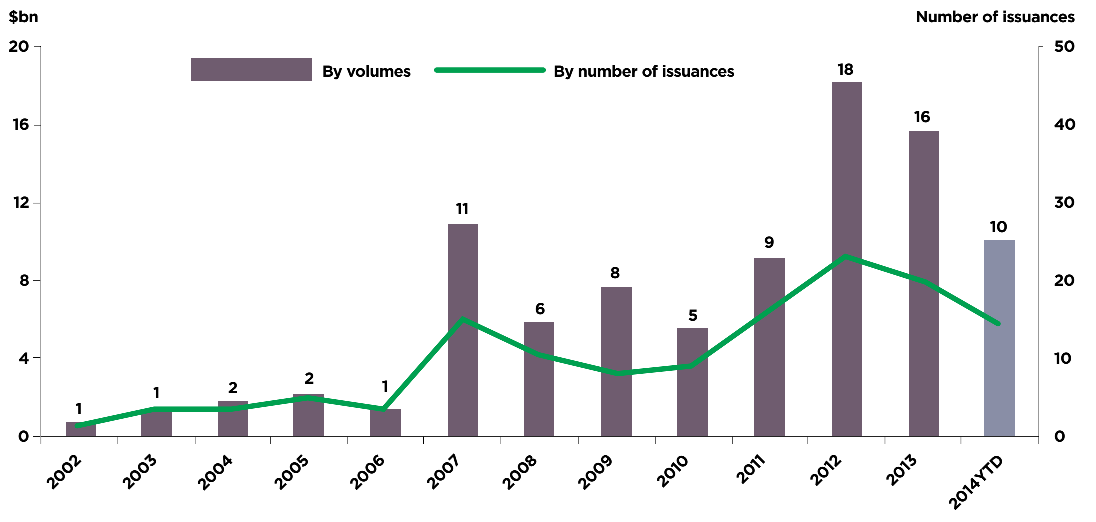
The half year witnessed a large amount of debut issuances, mostly from Dubai-based corporates, namely Dubai Investments Park, DAMAC Real Estate, the Investment Corporation of Dubai and Emaar Malls.

With international sukuk evolving into a cross-border market, Dubai announced a three-year programme to promote the city as the world's Islamic banking and finance hub in 2013. The city is currently the third-largest venue for sukuk listings globally, via the NASDAQ Dubai stock exchange, and it aims to focus on the role of financing services in the Islamic economy to reach its goal.

Innovation

In 2002, the Malaysian government was the first sovereign to issue an international sukuk and it paved the way for other sovereigns, such as Bahrain, Indonesia, Pakistan, Qatar and Turkey. The $600m floating-rate trust certificates had a five-year tenor and employed the sharia concept of ijara (leasing). Since then, notable

INTERNATIONAL SUKUK ISSUANCE, 2002-2014 YEAR TO DATE



SOURCE: DEALOGIC

global sukuk transactions have taken place, such as the first-ever exchangeable sukuk issued by Malaysian sovereign wealth fund Khazanah Nasional Berhad in 2006. In 2011, the Malaysian government again displayed its innovative leadership by being the first sovereign to issue an international sukuk, using the concept of wakala (agency). The sukuk assets under the wakala principle comprise: (i) a tangible asset component consisting of leasable assets and sharia-compliant shares; and (ii) a murabaha (marked-up) receivable component arising from the sale of sharia-compliant commodities.

In light of the new capital adequacy standards related to market risk, sukuk has also been a tool for banks to comply with regulatory requirements. In November 2012, Abu Dhabi Islamic Bank (ADIB) issued the world's first sharia-compliant hybrid, tier 1, perpetual sukuk. The main challenges of the deal were to merge the conventional context with the Islamic principles. Structured as a hybrid, tier 1 instrument ('preferred shares', as referred to in the US), the flexibility to cancel coupons and the perpetual nature of the instrument provided the equity-like features and recognition. In March 2013, Dubai Islamic Bank followed ADIB's lead by issuing tier 1 capital certificates. Both deals attracted strong demand, with oversubscription levels of approximately 15 times.

While formal legislation and implementation of Basel III remain at a preliminary stage in the UAE, in June 2014, Al Hilal Bank printed the world's first-ever, US-dollar, bank-capital sukuk issuance with Basel III-compliant mechanics.

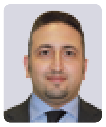
Longer tenors and increased sizes

Tenors have extended towards the long end of the curve and deal sizes have increased. Apart from the perpetual tier-1 capital instruments, the Dubai government issued the longest-ever sovereign sukuk with a 15-year tenor in April 2014. The extension of the tenor resulted in increased interest from US offshore account holders, relative to the 10-year offering by the Dubai government a year earlier. In 2013, Saudi Electricity Company issued a $2bn, dual-tranche sukuk with 10-year and 30-year tenors in Regulation S/Rule 144A format. In April 2014, the utility company tapped the market again with a similar dual tranche, increasing the size of the 10-year tranche by $500m. Meanwhile, in February 2014, the Saudi-based multilateral development bank, the Islamic Development Bank, successfully raised $1.5bn via a five-year sukuk issuance. This deal represented a landmark transaction, since it was the tightest spread ever achieved for an international benchmark sukuk issuance. In addition, the transaction is the largest amount that the Islamic Development Bank has raised through the capital markets.

In order to increase the efficiency of the Islamic market, a few organisations are trying to build up a regulatory framework. The most active is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). By issuing standards (88 to date) on sharia, accounting, auditing, governance and codes of ethics, the AAOIFI has enhanced the standardisation and harmonisation of international Islamic finance. The AAOIFI standards are accepted globally, since they are now adopted and implemented in a few countries and by the market, with the Dubai International Financial Centre leading the pack.

Despite the absence of standardisation in sukuk structures, international sukuk issuances have predominantly adopted the ijara, wakala and, in cases of bank capital, mudaraba sharia concepts. Investors' increasing familiarity with these concepts, especially non-Islamic-based investors, has reduced, or even eliminated, the need to educate investors on the underlying sukuk structures.

Having said that, and looking ahead, there are areas that can still be explored in international sukuk, such as project finance sukuk and other forms of asset-backed sukuk. These areas could benefit many GCC countries and issuers that need to fund a large number of infrastructural developments and capital expansions.



Fawaz Abu Sneineh is MD – head of debt capital markets at the National Bank of Abu Dhabi

The views expressed in this article are those of the author and not necessarily those of the bank