

The Rise of Sukuk

This year, Britain became the first non-Muslim country to issue sukuk, an Islamic financial instrument equivalent to a bond or mortgage, leading to £2.3bn in orders. Hong Kong quickly followed and now Société Générale and Bank Tokyo-Mitsubishi, as well as the governments of Luxembourg and South Africa, are planning their own sukuk issues. Dr Heba Abou-El-Sood from Cairo University and Dr Marwan Izzeldin from Lancaster University Management School tell us why the sukuk is one to watch

In June 2014, Britain became the first non-Muslim country to issue sukuk, an Islamic financial instrument equivalent to a bond or mortgage. Hong Kong followed Britain's suit in September and the governments of Luxembourg and South Africa expressed their planned sukuk issuance by the end of 2014. Britain's issuance has attracted above £2.3bn in orders while the Hong Kong issuance attracted US\$4.7bn in orders. The huge market demand for sukuk has encouraged non-sovereign sukuk issuance to tap into the fast growing Islamic finance market of approximately US\$2tn. The Goldman Sachs successful sukuk issuance in September has motivated Société Générale and Bank Tokyo-Mitsubishi to follow the lead by the end of 2014.

Non-Islamic financial institutions have been devising sukuk instruments that are compliant with Islamic Shari'a rules where the possessor is entitled to part-ownership of an asset and then receives income either from profits generated by that asset or from rental payments made by the issuer. This structure resolves the issue of receiving non-Shari'a compliant interest payments on lent money, as in a standard bond. Therefore, if a customer wants to buy a house, the bank will buy the house itself rather than lending money and receiving interest.

The customer then has two options depending on the structure of the Islamic sukuk transaction. He can either buy the house back from the bank at an agreed-upon, value paid in installments in

a partnership-like structure (*murabaha sukuk*) or he can make monthly payments that comprise a rental portion and another portion that goes towards the purchase price until he owns the house (*ijara sukuk*). Non-Islamic financial institutions have to devise financial instruments conforming to Shari'a requirements and fitting the sukuk structure. The urging question has been whether the appeal to a growing market has been the sole motive for non-Islamic banks to issue Islamic Shari'a-compliant instruments.

With Basel III banking regulations being phased in starting 2013, several Islamic banks have issued subordinated instruments, including those in the United Arab Emirates, Saudi Arabia, Turkey, and Pakistan to boost their regulatory Tier 1 and Tier 2 capital. Banks in Malaysia have started to use of investment partnership structures (*murabaha*) for their sukuk, which will be classified as Tier 2 capital on the balance sheet. Tier 1 capital constitutes core equity and disclosed reserves; and Tier 2 capital comprises supplementary capital of other reserves, provisions, subordinated debt, and hybrid instruments. Basel III regulations allow part of the minimum Tier 1 capital ratio to be in the form of additional Tier 1 capital, a layer of additional capital that is perpetual in nature.

The main purpose of Tier 1 and Tier 2 capital is to absorb losses during economic shocks. With additional Tier 1 capital, Basel III is signaling opportunities of using instruments that are potentially hybrid in nature and provide fixed rates of return.

While the growth of sukuk issuance has been targeting market opportunities, there have been massive opportunities for the capitalization of Islamic and non-Islamic banks to meet regulatory capital adequacy needs. Out of the total volume of sukuk instruments issued to date, 59% support the Basel III Tier 2 capital requirements while 41% support the Tier 1 capital. Recently, sukuk compliant to Basel III has formed an alternative source of finance for institutions that face difficulties in raising capital through stock issuance as financial instability depresses stock market prices.

After Basel III new regulatory capital adequacy rules, there has been a market gap for the supply of instruments that are potentially hybrid in nature (equity callable at the discretion of the issuer), subordinated to depositors, have no maturity date or perpetual, and offer fixed rate of return to sustain the perpetual nature. This unexploited market gap has been filled with globally growing sukuk instruments, boosting the regulatory capital of issuing banks and reinforcing the role of Islamic finance in the global banking industry. 

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