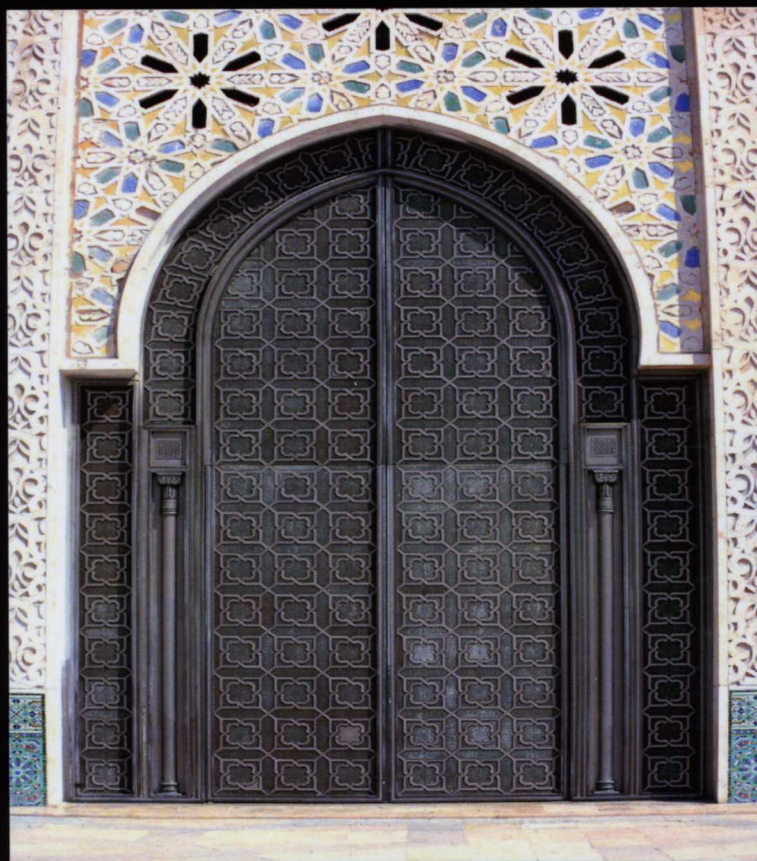


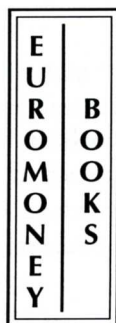
# Global Growth, Opportunities and Challenges in the *Sukuk* Market



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**Sohail Jaffer**

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## The role of *Sukuk* in meeting global development challenges

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### Introduction

Over the last decade, we have observed with keen interest the emergence of Islamic finance on the international financial landscape. Following on from the significant developments that have occurred in what we view as the 'core area' for this market, the predominantly Muslim countries, we are now witnessing the growing globalisation of Islamic finance. This globalisation takes two principal forms: (1) increasing interest in Islamic finance in the world's leading conventional financial centres, where we have seen significant discussion of Islamic finance taking place in cities such as New York, London, Milan, Paris, Hong Kong, Singapore, Seoul and Tokyo; and (2) increasing integration of Islamic finance with the conventional financial world, evidenced, for example, by the significant portion of *Sukuk* issues originated in Gulf Cooperation Council (GCC) countries that are placed with conventional investors within GCC and the West.<sup>2</sup>

Although the rapid growth of Islamic finance is often attributed to the excess liquidity in the GCC countries after the recent oil boom, we believe there are a number of other factors that have contributed to the successful development of Islamic finance. Such factors include the sound track record of Islamic financial institutions, many of which showed particular resilience during the global financial crisis, the constructive role played by conventional intermediaries through financial engineering and knowledge-sharing, the advancement in research and the wider recognition of Islamic finance globally.

However, despite the tremendous growth in this emerging market we have seen over the past two decades, the size of Islamic finance relative to global financial markets remains very small. By some estimates, the market size now exceeds US\$1 trillion but, when compared to global financial markets, that figure represents less than 1% of global financial system. Therefore, the remaining growth potential for Islamic finance would appear to be enormous.

We believe the development of modern Islamic finance has been largely a demand driven phenomenon, propelled by previously unmet demand from investors for products that are more compatible with their religious faith, and we see no sign that this demand driven momentum will lessen in the near future. Considering the growing share of global GDP represented by predominantly Muslim countries, as well as their youthful demographic make-up, the demand for financial products complying with *Shariah* law should actually continue to accelerate over the next decade.

In this chapter, we will look at the future growth potential of Islamic finance in general and particularly of *Sukuk* from our perspective as officers in the Treasury of the International Bank for Reconstruction and Development (known in the capital markets, as the 'World Bank'). The World Bank is a significant player in the conventional capital markets, issuing approximately US\$30 billion of bonds each year, and having approximately US\$75 billion under management and a swap book totalling around US\$250 billion. Although the views we express in this chapter are our own personal views and in no way represent the official position of the World Bank, sitting in a global development institution naturally influences the way we look at this market. After first briefly summarising the history of the World Bank's engagement in Islamic finance, we will look at the *Sukuk* market, and consider how *Sukuk* financing could play a greater role in helping to meet global development challenges.

### **The World Bank's involvement in Islamic finance**

The World Bank recognises the importance of Islamic finance but also realises that it is not in a position to be the leader in the global Islamic finance industry. Such a leadership role is better suited to the private sector, as well as policy-makers and other stakeholders such as the Islamic Development Bank (IDB) and governing bodies in the major markets for Islamic finance. Instead, the World Bank has tried to focus its involvement in this market on areas where there is synergy with the World Bank's development mandate, and where it sees a role for its particular development finance expertise, convening power and transaction execution capabilities.

The engagement of the World Bank in Islamic finance has primarily been focused on research and knowledge sharing activities through speaking engagements at international forums, and through organising workshops and seminars to disseminate knowledge. Responding to the need to manage the growing volume of such activities and to further develop its work in this area, the World Bank established an Islamic finance working group in 2007 that brought together various experts across the World Bank Group. In addition, the World Bank has collaborated very closely with several key stakeholders in Islamic finance, such as the IDB in Jeddah and the Islamic Financial Services Board in Kuala Lumpur, on various technical and non-technical areas.

### **The World Bank's history as an issuer in the *Sukuk* market**

The World Bank issued its first, and thus far only, *Sukuk* in 2005 in Malaysia. The transaction was structured using the debt-based principle of *bai bithaman ajil*, with a size of Malaysian ringgit (RM) 760 million (equivalent to approximately US\$200 million at the time of issuance). The same principle was also the basis of a RM500 million *Sukuk* issued around the same time in Malaysia by a sister institution of the World Bank Group, the International Finance Corporation (IFC). More recently, the IFC issued a US\$100 million *Sukuk* in 2009 that was listed on Nasdaq Dubai and the Bahrain Stock Exchange.

Since its Malaysian issue in 2005, the World Bank has explored the possibility of structuring and issuing *Sukuk* in other markets. However, it faces a considerable challenge in finding a suitable structure, given the basic business of the institution is to provide conventional financing to its sovereign members for development. As a result, the majority of the World Bank's assets are conventional interest bearing loans. Even the office buildings that the World Bank owns would provide

a less than ideal basis for a *Sukuk* issuance since much of the business that goes on inside those buildings relates to the making of interest bearing loans and other conventional investment activities.

### **Suitability of *Sukuk* as a development tool**

Despite the challenges for the World Bank to appear itself as a frequent *Sukuk* issuer, we believe this market is in many ways ideally suited to be an important source of finance for development. Since its first bond issue in 1947, the World Bank, and its sister multilateral development institutions that came later, have proven that the global bond markets provide an enormous pool of capital that can be put to work productively to fund economic development and poverty alleviation.

The *Sukuk* market should similarly be seen as a way to channel the world's growing pool of *Shariah*-compliant capital to uses that promote sustainable and equitable economic development. In fact, given the underlying tenets of Islamic finance put great emphasis on social justice and social welfare in all economic transactions, the marriage of the *Sukuk* market with the goal of development and poverty reduction would appear to be a perfect match.

The challenge lies in developing the *Sukuk* market into a sufficiently liquid and robust market that can provide financing in volumes large enough to meaningfully address development challenges. At present, the *Sukuk* market is essentially a niche market populated largely by isolated, one off issuances. On the other hand, the extent of the financing that is needed in the area of poverty alleviation is enormous,<sup>3</sup> as is the growing pool of *Shariah*-compliant savings that is potentially available. Thus, overcoming the limitations that currently exist in the *Sukuk* market in order to unleash its potential as a source of development finance is a critical development imperative.

### **Limitations of the *Sukuk* market**

The issuance of *Sukuk* to date has been concentrated in Malaysia and the Middle East, particularly in Bahrain. Outside those two markets, *Sukuk* occupies only a very small place in the capital markets landscape. We believe the principal limitations on the development of the *Sukuk* market are the following.

First, the *Sukuk* market suffers from a lack of frequent sovereign issues. In particular, high quality sovereign issues are largely absent from this market.<sup>4</sup> Frequent, high quality sovereign issuance plays an important role in the development of all capital markets, as such issues serve the critical purpose of a building a benchmark yield curve for the market. Without such a benchmark yield curve, it is difficult for other issuers as well as investors to access the market with confidence.

Second, many investors in this market tend to buy and hold *Sukuk* investments until maturity and, as a result, there is almost no secondary market in most *Sukuk* issues. The prevalence of 'buy and hold' investors in this market is largely a consequence of the acute lack of supply. In other words, many investors hold *Sukuk* to maturity because they know that if they sell a *Sukuk* it will be difficult to find another *Sukuk* to replace the one they sold in their portfolio.

Third and directly related to the point above, the lack of liquidity of most *Sukuk* issues hampers the growth of the market. Investors that place a high value on liquidity may avoid *Sukuk* entirely because of the absence of a secondary market. The illiquidity also harms dedicated *Sukuk* investors, because it leads to comparatively large bid-ask spreads and limits their investment strategies and portfolio diversification opportunities.

The global financial crisis highlighted in stark terms the importance of liquidity. As a result, the lack of liquidity is increasingly detrimental to the market and directly impacts the assessment by both investors and regulators of the overall asset quality of *Sukuk*.

The trend of buying and holding and the corresponding lack of liquidity of *Sukuk* have serious implications for portfolio management. As a fixed income security ages, it moves from one benchmark to another. For example, a five year bond may be initially included in a one-to-five year benchmark, but as it ages and the remaining maturity comes closer to three years, the bond may be dropped from a one-to-five year benchmark to a one-to-three year benchmark. In the conventional markets, periodic 're-balancing' of portfolios to reflect the change in the remaining duration of outstanding holdings is relatively inexpensive to achieve, but in case of *Sukuk*, where the secondary market is very shallow, re-balancing could negatively impact portfolio performance in a material way.

Fourth, the complexity of *Sukuk* structures is another impediment to the development of this market. *Shariah* compliance is often achieved through creating a complex set of cash flows, and the prospectus for even a relatively simple *Sukuk* will generally include a cash flow diagram replete with multiple boxes and arrows. Essentially, this is a market where every product is a structured product, even ones that replicate, in terms of credit risk, plain vanilla, unsecured bonds.

Like the importance of liquidity, the global financial crisis also drew attention to the dangers of highly complex structured products. Specifically, such products are difficult to value, as well as to unwind in the event of a default. Because of the similarity of *Sukuk* with conventional asset securitisation, many of the same banks and professional advisers who dominated the market in complex collateralised debt obligations (CDOs) and other complex products that suffered significant downgrades and defaults during the financial crisis are also leaders in the business of structuring *Sukuk*. Although the *Sukuk* market proved itself to be more resilient than many segments of the CDO market during the financial crisis, the complexity of *Sukuk* structures may continue to discourage participation from many investors and issuers who were burned before by structured products.

Fifth, the lack of uniform interpretations across jurisdictions further hinders the growth of the market. Structures that are deemed acceptable in one market may not be equally accepted in another jurisdiction. The most frequently cited example of this divergence in interpretation is the difference between structures that are considered tradable in Malaysia and those that can be traded in most Gulf countries. Such a lack of uniformity limits the depth of the market for any particular *Sukuk* issue.

Sixth and lastly, there are concerns about the lack of legal certainty in the *Sukuk* market. For example, the extent to which courts will consider *Shariah* compliance in evaluating the enforceability of an Islamic finance contract remains an open question in most jurisdictions. As a result, there is a risk that a contractual obligation that would otherwise be found to be enforceable under the governing law of the contract may nonetheless be determined to be unenforceable due to some deficiency in its compliance with *Shariah* principles. This risk was highlighted by the 2009 English High Court judgment in the *Investment Dar Company KSCC v. Blom Developments Bank* case. The court in that case found reasonable grounds for a claim by an Islamic finance house that its obligations under an English law governed contract were unenforceable because the contract was not truly compliant with *Shariah* law.

There is also lack of legal certainty with respect to the recourse to assets underlying many *Sukuk* issues in the event of the insolvency of an obligor. While the existence of an underlying transaction involving real assets is an essential component of most *Sukuk* structures, many *Sukuk* issues are 'asset-based' as opposed to 'asset-backed' or 'asset-linked'. In an asset-based structure,

there is rarely a security interest granted in, or recourse to, the assets involved in the transaction. This issue was highlighted in *Shariah* ruling of Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) which criticised existing structures on these grounds. In particular, *Shariah* experts have criticised that many agreements underlying asset-based *Sukuk* transactions stipulate that the underlying assets are to be bought back at par instead of prevailing market value.

### **The role of *Sukuk* in meeting development challenges going forward**

Although the obstacles and challenges described above are significant, none of them appears to be insurmountable. Greater standardisation of structures and documentation should, for example, cure many of the current problems we see in the market related to excessive complexity and lack of legal certainty. Moreover, as these legal and structuring issues are addressed, more investors should be attracted into the market, which should in turn help alleviate the lack of liquidity and market depth. Therefore, we believe the limitations we have identified are not endemic to *Sukuk* as a product, but rather simply represent natural growing pains for a market that is still in the relatively early stage of its development.

Assuming we are correct that these limitations can be cured, we believe the *Sukuk* market has great potential to function as a bridge between the growing pools of *Shariah*-compliant capital, on one hand, and the massive need for poverty alleviation funding, on the other. In fact, it would be a great missed opportunity if a thriving socially responsible *Sukuk* market fails to develop, given that the explicitly ethical nature of Islamic finance creates a natural rationale for using *Sukuk* as a development tool.

Of course, Islamic finance offers other instruments that similarly can be used to fund development projects. Equity investment, for example, is generally *Shariah*-compliant provided the underlying business venture is not proscribed by *Shariah* principles. However, the pool of potential equity investors in poverty reduction projects is substantially more limited than the potential investor base for a fixed income type of instrument such as *Sukuk*.

Furthermore, one of the core principles of Islamic finance and consequently of *Sukuk*, is to promote risk sharing among providers and users of capital. For poverty alleviation projects, a financing instrument that demands a wider distribution of risks offers a number of potential benefits. For example, wider risk sharing demands closer monitoring by intermediaries and investors of the underlying project. Such monitoring should have a beneficial impact on poverty alleviation projects that can sometimes be susceptible to waste, corruption and governance problems. More parties having direct financial exposure to a project means more eyes on the project and more incentive to require safeguards to protect against the leakage of funds.

In addition, the potential market for *Sukuk* issues that fund economic development is not limited only to *Shariah*-compliant investors. There are growing numbers of socially responsible investors whose investment mandates correspond in many respects with the social and ethical principles that underlie Islamic finance. In the United States alone, socially responsible investors are estimated to hold roughly US\$2 trillion of assets. That figure far exceeds most estimates of the current size of the entire Islamic finance industry. Therefore, if socially responsible *Sukuk* issues can be marketed to appeal to both *Shariah*-compliant and conventional investors, the potential impact of these issues will be much greater.

Given the scale of the development challenges facing the world, more innovative uses of *Sukuk* must also be considered. The International Financing Facility for Immunisation (IFFIm), for

example, is a new way of mobilising development resources using the conventional capital markets. IFFIm, which was established in 2006, is a supranational entity that receives long term pledges from developed world sovereign donor countries<sup>5</sup> and, based on those pledges, issues bonds to investors. The proceeds of these bond issues are used to fund immunisation, vaccine procurement and health systems strengthening projects in 70 of the poorest countries of the world. The bonds are then repaid over time by the long term pledges made by IFFIm's sovereign donors. While IFFIm has thus far only accessed the conventional bond markets, the same objectives could be met using a *Shariah*-compliant structure that utilises the *Sukuk* market.

IFFIm also represents a precedent for how development institutions like the World Bank can promote innovative uses of the *Sukuk* market without actually acting as the *Sukuk* issuer or underlying obligor. For IFFIm, the World Bank acts as treasury manager and provides various services, from arranging IFFIm's bond issues to managing IFFIm's liquidity pending disbursement. In this way, IFFIm is able to make use of the existing institutional framework and transaction processing capabilities of the World Bank and is spared the considerable expense of creating such a framework for itself. Efforts to create innovative *Sukuk* based financing vehicles should similarly seek to make use to the extent possible of existing institutions, whether they be multilateral institutions, like the World Bank and IDB, or central banks and other domestic agencies of countries with significant experience in Islamic finance.

These institutions can also play a constructive role in the development of the *Sukuk* market through offering full or partial guarantees. Development and poverty reduction projects in many poor countries would present significant economic and political risks. Investors in such projects could be exposed to risks ranging from currency instability and the imposition of exchange controls to the expropriation of property to the impact on the projects of war and civil disturbances. To the extent that these risks can be removed or otherwise substantially mitigated through official sector guarantees, the projects become much more viable for private sector investors.

Given the increasing global threat posed by climate change, *Sukuk* could also be adapted to fund projects that aim specifically to promote low carbon development. In the conventional markets, the World Bank was a pioneer in this area when it issued its first 'green bonds' in 2008. The proceeds of green bonds support the World Bank's lending to eligible development programmes that are designed to tackle the causes and consequences of climate change in the developing world. Following the World Bank's lead, green bonds have also been issued by, among others, the European Bank for Reconstruction and Development, the European Investment Bank and Nordic Investment Bank. A 'green *Sukuk*', in which the proceeds are earmarked to achieve specific environmental objectives, would seem to be a perfect product to connect environmentally focused conventional investors and *Shariah*-compliant investors.

The contribution of micro-finance in stimulating economic development and growth cannot be over-emphasised. The idea of 'banking-the-non-bankables' through micro-finance is catching attention of financial institutions who are even considering it as profit-making proposition. Given the World Bank's goal to alleviate poverty in the developing nations, micro-finance and small and medium enterprise (SME) financing can play an important role. A debt-based micro-finance model like Grameen is not acceptable in *Shariah* but there are several examples of successful *Shariah*-compliant micro-finance. Assets generated under such *Shariah*-compliant micro-finance and the financing of SMEs can be securitised in form of a *Sukuk* issuance by the World Bank. This can have three major benefits. First, this will bring the cost of available financing down which otherwise



is considerable high in most of micro-finance ventures. Second, with the introduction of *Shariah*-compliant micro-finance, the access-to-finance for the poor will improve especially of those who shy away from conventional financing due to their commitment to *Shariah*. Finally, promotion of SME will lead to further economic development.

Sitting in the Treasury of the World Bank, we find common ground between the development mandate of our institution and the principles of Islamic finance, and we believe *Sukuk* could be a vehicle to connect the two. Although we recognise there are considerable limitations with the current state of the *Sukuk* market, we believe these limitations can be overcome and that the future growth potential of *Sukuk* as a development finance tool is enormous.

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<sup>1</sup> Michael Bennett is a Lead Financial Officer and Zamir Iqbal is a Lead Investment Officer in the Treasury of World Bank. The findings, interpretations and conclusions expressed herein are those of the authors and do not necessarily reflect the views of the World Bank or its affiliated organisations.

<sup>2</sup> For example, 40% of the US\$3.52 billion *Sukuk* issued by Nakheel in 2006, at the time the largest *Sukuk* ever issued, was reportedly placed with European investors.

<sup>3</sup> For example, the World Bank estimates the cost of achieving the Millennium Development Goals by 2015 at approximately an additional US\$40 billion to US\$60 billion a year, over and above the resources already committed.

<sup>4</sup> Triple-A rated *Sukuk* issuance has to date been dominated by only one issuer, the IDB.

<sup>5</sup> IFFIm is supported by legally binding pledges from the United Kingdom, France, Italy, Norway, Spain, the Netherlands, Sweden and South Africa, and an additional commitment has been announced by Australia.