



The Sukuk Market Comes of Age

PERSPECTIVE FROM FRANKLIN LOCAL ASSET MANAGEMENT GROUP

Islamic finance has been one of the fastest-growing areas of the financial services sector, with an estimated asset value over US\$1.8 trillion, and continuing to grow at an annualized rate of nearly 20%.¹ Since the 1990s, Islamic finance has grown from a focus on *Shariah*-compliant commercial banking and project finance to encompass a range of products and services that is compliant with Islamic law, including equity funds, real estate funds, and liquidity management tools and fixed income instruments called “*Sukuk*.”

What Are Sukuk?

Sukuk is the plural of the Arabic word *Sak*, literally translated as title deed. They are financial certificates structured to comply with Islam’s prohibition on the charging or paying of interest (known as *Riba*) that grant an undivided interest or share in an underlying asset along with the profits, cash flows and risk commensurate with such ownership. Sukuk are often referred to as the Islamic equivalent of bonds.

The principle of risk sharing is relatively straightforward and lends itself particularly well to investments in listed equity, private equity and real estate, which is where more than two-thirds of *Shariah*-compliant mutual fund assets are currently allocated.

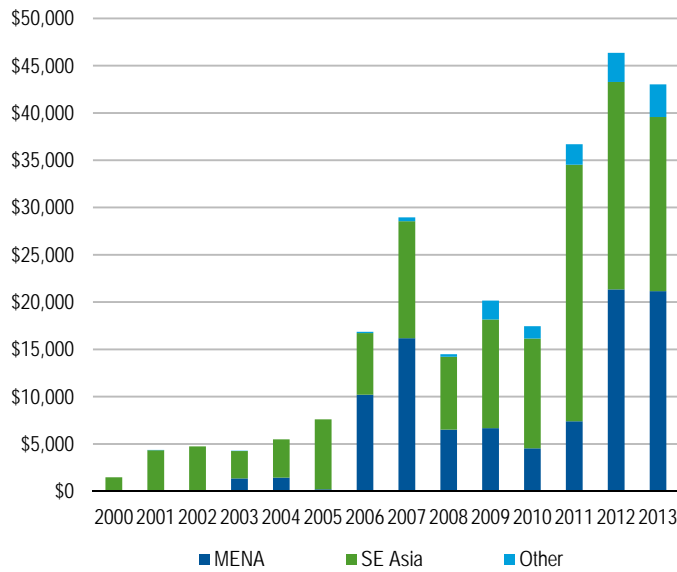
While the core principles of Islamic finance are over 1,500 years old, the first modern Sukuk were launched in Malaysia at the beginning of this century. Bahrain pioneered the *Sukuk Al Salam* and *Sukuk Al Ijara* instruments to the Islamic market in 2001 while Malaysia introduced the global *Sukuk Al Ijara* in June 2002.

Current demand, which comes from Islamic financial institutions as well as fund managers and high net-worth individuals, far outstrips supply, reflecting the fast growth of the Islamic banking industry and the increasing appetite for credible, *Shariah*-compliant, liquid securities. Global Sukuk issued by corporations and sovereigns in 2013 slipped 15% to US\$115.5 billion from 2012’s record US\$136 billion, with Malaysia, Indonesia and Gulf Cooperation Council (GCC) countries still accounting for the lion’s share of Sukuk issuance.²

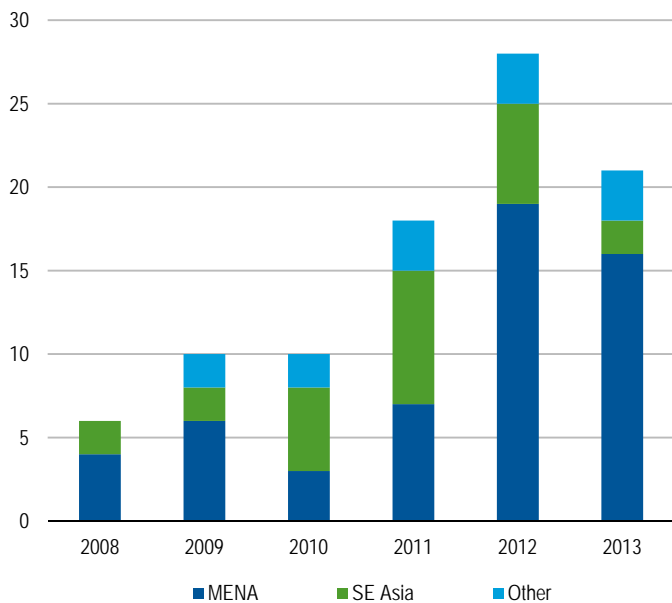
Issuers tend to be banks, sovereigns and sovereign-backed entities. Until recently, the funds collected tended to be used mainly to finance infrastructure-related projects, although there has been significant diversification of issuers, sectors and underlying assets in recent years. There has also been a noticeable globalization and expansion of Islamic finance products outside their traditional heartland. For international issuers, Sukuk offerings are seen as a way of diversifying their funding base and boosting their profile in the Muslim world, while non-Muslim governments are keen to foster potentially lucrative domestic Islamic finance industries.

The avoidance of *Riba* and the equitable sharing of risks are overarching principles of Islamic law. All Islamic financial contracts, including Sukuk contracts, are drawn up on the basis of risk sharing and the avoidance of paying or receiving interest. *Shariah* principles require wealth to be generated from legitimate trade and asset-based investments, and financing to be raised only in relation to specific and identifiable assets, with the use of money for the purposes of making money (or earning interest) being expressly forbidden.

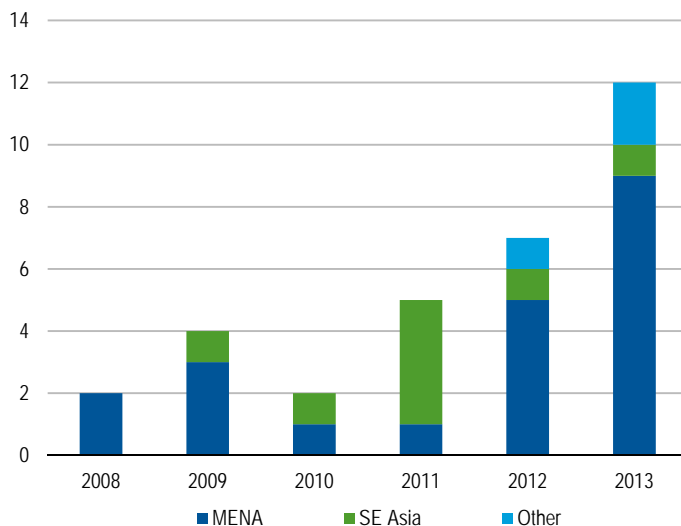
Figure 1: Global Sukuk Issuances
 Issuances (\$Millions, USD)
 As at 31 December 2013



Number of Issues over \$500 Million



Number of Issues over \$1 Billion



Source: Bloomberg LP, 31 December 2013.

How Do Sukuk Differ from Conventional Bonds?

The fundamentals of Islamic finance require that all contractual arrangements must be transparent, clear to all parties, without unfair punitive clauses, and with a proper alignment of interest. Transactions must not involve excessive risk or speculation due to uncertainty, investments should have a social and an ethical benefit to the wider society (beyond pure return), and there should be no involvement in unethical businesses.

In practical terms, these fundamentals mean the following:

While a conventional bond is a promise to repay a loan, Sukuk constitute partial ownership in receivables (*Sukuk Al Murabaha*), a lease (*Sukuk Al Ijara*), a project (*Sukuk Al Istisna*), a business or partnership (*Sukuk Al Musharaka*), or investment (*Sukuk Al Istithmar*). In other words, Sukuk represent ownership of real assets, whereas conventional bondholders own debt.

1. The prohibition of interest requires that Sukuk, unlike conventional bonds, do not pay interest. Instead, Sukuk are structured so that coupon payments are really lease, rental or profit payments that are passed through to Sukuk holders.
2. Unlike conventional bonds, the principal amount is not always guaranteed by the issuer at maturity. However, a separate purchase undertaking, by a third party or the issuer in some cases, gives Sukuk holders the comfort that the principal will be repaid in full. This is an important technique to achieve capital protection without resorting to debt-like structures.
3. Sukuk instruments may not invest in gaming, tobacco, pornographic concerns, alcohol manufacturers and distributors, conventional banks or insurance firms.

For an investment to be considered compliant with Shariah, it is independently reviewed and endorsed by a supervisory board of Islamic scholars with extensive Shariah and technical financial understanding. Supervisory boards provide initial approval on the objectives and strategy for a product or transaction, as well as ongoing supervisory and monitoring services to ensure continuous adherence to internationally accepted Shariah principles and standards.

Supervisory boards—with guidance provided by Islamic authorities such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),³ the Islamic Financial Services Board⁴ and the Islamic International Rating Agency⁵—must determine that investments comply with Shariah principles. Sukuk financial contracts meet these conditions. But while Sukuk must comply with Islamic law, they are governed also by the secular legislation under which they were issued, just like conventional bonds.

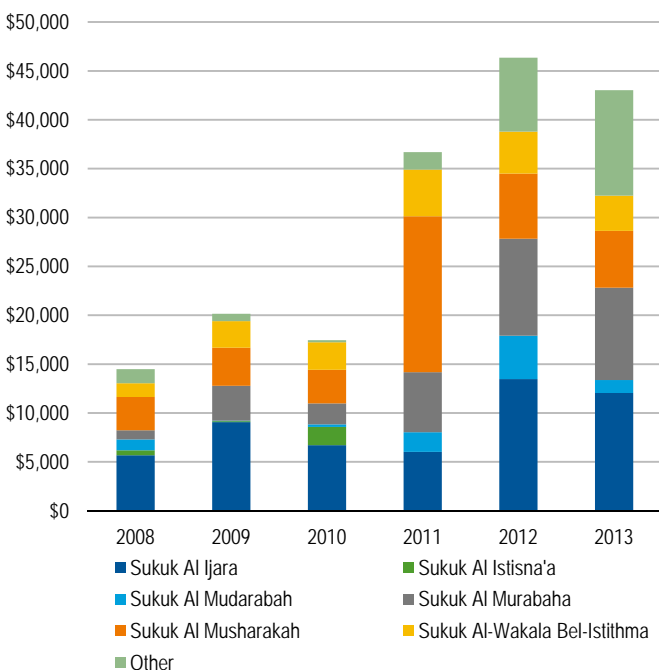
How Are Sukuk Structured?

Although there are various kinds of Sukuk structures, depending on the nature of the underlying asset (see below), they all endeavor to generate returns for investors without infringing on Shariah law's prohibition on the payment or receiving of interest. In addition, as discussed above, all Sukuk provide investors a common share in the ownership of the assets linked to the Sukuk (although, critically, this common share does not represent a debt owed by the Sukuk issuer).

The three most popular Sukuk contracts by issuance volume are Sukuk Al Ijara, Sukuk Al Musharaka and Sukuk Al Murabaha.

Chart 2: Annual Global Sukuk Issuance (\$Millions, USD) by Islamic Structure

As at 31 December 2013



Source: Bloomberg LP, Franklin Templeton Investments (ME) Limited. Data excludes short-term issuance by central banks and other restricted interbank offerings.

Sukuk Al Ijara are the most common, straightforward type of Sukuk contract, accounting for over one-third of Sukuk issuance, according to estimates by Bloomberg and Franklin Templeton Investments (ME) Limited. “*Ijara*” is broadly understood to mean a lease. Sukuk Al Ijara are therefore sale-and-leaseback structures that use revenues from an underlying asset, such as a building, to pay investors. An issuer of Sukuk Al Ijara buys an investment for a customer and then leases it back for a specified period. Returns come in the form of profit from rent, not interest, which is forbidden.

As with all Sukuk structures, Sukuk Al Ijara rely upon either the performance of an underlying asset or a contractual arrangement with respect to that asset. Sukuk Al Ijara issuers must therefore identify tangible assets on their balance sheets to back the Sukuk.

Sukuk Al Musharaka is another form of Sukuk contract, derived from the word “*Shirkah*” which means partnership, in

which all partners contribute capital and labor. Profit is shared among partners at an agreed-upon ratio or declining basis. Losses, however, are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise. Essentially, a Musharaka is akin to an unincorporated joint venture but may, if required, take the form of a legal entity.

Sukuk Al Murabaha is another basic building block of the Islamic financial industry. Murabaha is understood to refer to a contractual agreement according to which a financier buys a good or an investment and then sells it on to a customer with a markup on a deferred basis. Customers are expected to be able to meet their payment obligations upon delivery. The advantage of Murabaha contracts is that they offer a form of credit to customers to make a purchase or an investment without having to take out an interest-bearing loan.

However, Sukuk Al Murabaha cannot be traded on the secondary market because Shariah does not permit trading in debt except at par value, thus limiting their use to short-term funding, either in the form of money market liquidity management tools or deposit taking by Islamic commercial banks.

Other popular Islamic contracts that have been adapted to issue Sukuk include:

Mudarabah is a form of partnership where one party supplies the capital (*rabulmal*) while the other manages it (*mudarib*). Profit is shared among parties at an agreed-upon ratio. Losses are borne by the provider of funds (except in the case of gross misconduct by the other parties).

Istisna is a preproduction instrument used when an item or an asset needs to be manufactured or constructed. The price of the item or asset should be known as well as the time of payment.

Wakala is an agency appointment whereby one party entrusts another party to act on its behalf according to specific terms and conditions. A principal appoints an agent (or *wakeel*) to invest funds provided by the principal into a pool of investments or assets, and the agent manages those investments on behalf of the principal for a particular duration to generate an agreed-upon profit return.

The Market for Sukuk

With over 1.5 billion Muslims worldwide, representing approximately one-fifth of the world's total population and growing at the fastest rate among all major religious groups, the fundamental case for Islamic finance is compelling. While the industry evolved initially as an alternative form of financial intermediation, primarily to meet Muslims' desire for Shariah-compliant investments, it is now a complete and integral component of the mainstream global financial system. Estimated Islamic finance assets, including Sukuk, stood at US\$1.8 trillion at end-2013, having grown at a compound annual rate of 15% to 20% per year since 2000.⁶ The Malaysia International Islamic Finance Centre estimated that the amount

of Sukuk outstanding came to US\$269.4 billion at the end of 2013, with 95% of issuance concentrated in the Middle East North Africa region and Southeast Asia.⁷

The global financial crisis, and more recently, the eurozone debt crisis, have encouraged conventional institutions to show renewed interest in Sukuk, as these products are based on real assets. Demand from investors eager to tap into investments that combine relatively high yields with relatively low risks had global consultants Ernst & Young forecasting in 2012 that global demand for Sukuk will grow three-fold by 2017, to US\$900 billion.⁸ Would-be issuers have been scrambling to exploit this demand, with major Southeast Asian and Middle Eastern companies, together with global financial firms, showing increased interest in raising money through Sukuk instruments and Shariah-compliant products in general.

Data provider Zawya, a member of Thomson Reuters, estimates that total Sukuk sales (local- and foreign-currency issues, including short-term paper) came to US\$116 billion in 2013, a decrease of 15% over 2012's US\$136 billion due largely to a decline in issuance in Malaysia.⁹ Despite the dip, the outlook for issuance continues to remain strong, with a recent survey from Zawya suggesting issuance could rebound to US\$130 billion in 2014 and reach US\$237 billion in 2018, with Malaysia, Indonesia and GCC countries remaining the major issuers.¹⁰ An important milestone was recorded at the beginning of 2012 when Saudi Arabia successfully issued the country's first sovereign-guaranteed Sukuk to finance the expansion of Jeddah's international airport. This was the largest sovereign-guaranteed emerging-market debt issuance in a decade.

Other large issues followed in 2012, with Turkey issuing its first US dollar-denominated sovereign Sukuk, Indonesia selling its third global Sukuk, and Abu Dhabi Islamic Bank issuing the first perpetual Tier 1 capital hybrid Sukuk. As policymakers, multilateral institutions, Shariah scholars, banks and asset management companies develop, promote and innovate, Sukuk markets have become increasingly larger, more liquid, more diversified and better researched.

Sukuk's growth has been further supported by their performance relative to broader credit markets, which have been struggling with the fallout from the eurozone debt crisis and declining investor confidence in high-risk investments. Indeed, the Sukuk market proved relatively resilient throughout the financial crisis, and has largely outperformed many conventional fixed income indexes and displayed less volatility. The S&P Dow Jones Sukuk Index (in US dollars), for example, has returned on average about 4.8% a year in the seven years since its inception, despite the global financial crisis and the severe debt crisis in Dubai in 2009. Performance has accelerated in the past year, with the S&P Dow Jones Sukuk Index returning over 8.45% in the 12-months through 31 August 2014.¹¹

Chart 3: Global Sukuk Performs with Less Volatility Than Conventional Bonds

Growth of a \$10,000 Investment
Three-Year Period Ended 31 August 2014



Source: FactSet,¹¹ JP Morgan as at 31 August 2014. Global Sukuk represented by S&P Dow Jones Sukuk Index. Global Bonds represented by J.P. Morgan GBI Broad Index. Past performance is no guarantee of future results.

Challenges Facing the Sukuk Market

Perhaps the largest immediate challenge facing Sukuk is the mismatch between supply and demand. Surveys suggest that nearly 50% of Muslim investors would opt for an Islamic product with the right value proposition over a conventional product.¹² This rise in retail demand is reflected in double-digit growth in the Islamic banking industry, and the increased appetite for investment-grade, Shariah-compliant, liquid securities among corporate treasurers, as well as fund managers and high net-worth individuals. In fact, an International Monetary Fund (IMF) working paper found that Islamic financial institutions have experienced credit and asset growth at least twice as high as that of conventional banks since the global financial crisis.¹³

The gap between supply and demand is beginning to be addressed. A number of multinational companies (including HSBC, GE Capital and Nomura) and sovereign issuers outside the Muslim world (for example, Luxembourg, Japan, Australia, Ireland and France) have launched or are considering Sukuk issues, and will hopefully fill the supply gap in the medium term.

The Sukuk market did not emerge totally unscathed from the global financial crisis. Issuance plummeted between 2008 and 2010, and Shariah-compliant bonds in Saudi Arabia, Kuwait and the United Arab Emirates had to be restructured, prompting

complex debt negotiations and raising questions about governance. Lessons have also been learned from the defaults of certain Shariah-compliant issues during the financial crisis. Deals are being structured more carefully than they were, and the successful restructuring of a number of troubled issuers in the past two years has lifted investor confidence.

Important efforts to adapt Sukuk to the modern world are being undertaken. Malaysia leads the way in these efforts. Organizations such as the AAOIFI have made welcome moves toward standardization in accounting, financial reporting and regulation for Sukuk in the Middle East as well. Indeed, the disparity between Asian and GCC Sukuk markets is tending to diminish as both regions continue to grow and improve their financial architecture. In this regard, it is worth noting that Islamic finance experts in Saudi Arabia and Malaysia have recently teamed up to renew efforts to create common guidelines for Sukuk investments and a universal Shariah governance framework. Moves toward greater transparency in these areas should enhance the potential of Sukuk, as should moves to establish common, global accreditation for Sukuk deals.

There is still the perception that Sukuk are relatively illiquid. In fact, the market for Sukuk has already gained such momentum that secondary market liquidity has improved significantly, with bid-offer spreads that are comparable to those seen in the market for conventional bond instruments. The further development of Sukuk is being helped by increasing liquidity of money markets in GCC countries, as confirmed by declining interbank borrowing rates and increasing lending to the private sector. Under normal market conditions, the liquidity of international Sukuk issues of benchmark size is akin to that of conventional counterparts. However, like conventional bonds, the liquidity profile of a Sukuk issue will vary with time and is determined by its size, the credit quality of the issuer, and other, security-specific risks.

Market Participants

According to a report by the Malaysia International Islamic Finance Centre, global assets under management for Islamic funds reached US\$76.7 billion in December 2013, growing at a 9.41% compound annual growth rate over the past five years. Equities constituted about 34% of the total assets under management of Islamic funds, according to the report, followed by money market instruments at 19% and commodities at 15%.¹⁴ However, Shariah-compliant fixed-income product offerings are still limited.

In January 2010, Franklin Templeton GSC Asset Management was granted a license by Malaysia's Securities Commission to engage in regulated Islamic fund management. In the Middle East, Franklin Templeton Investments (ME) has been involved in Shariah-compliant asset management since 2000. Franklin Templeton has been awarded Shariah-compliant equity mandates in Asia and has managed a number of Global Sukuk mandates since 2008 and a Luxembourg-registered SICAV fund since 2012.

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WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business, and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year.

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1. Islamic Financial Stability Board, *Islamic Financial Services Industry Stability Report 2014*.

2. Source: *Zawya Sukuk Market Closes 2013 on a Positive Note 2014*.

3. An Islamic international, autonomous, nonprofit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry.

4. An international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

5. A rating agency established to provide capital markets and the banking sector in predominantly Islamic countries with a rating spectrum that encompasses the full array of capital instruments and specialty Islamic financial products.

6. Source: Islamic Financial Stability Board, *Islamic Financial Services Industry Stability Report 2014*.

7. Source: Malaysia International Islamic Finance Centre, *Global Sukuk Begins 2014 with Momentum*, 29 January 2014.

8. Source: Ernst & Young MENA, *Global Demand for Sukuk to Reach US\$900bn by 2017*, 9 September 2012.

9. Source: *Zawya Sukuk Market Closes 2013 on a Positive Note 2014*.

10. Source: *Zawya Sukuk Perceptions and Forecast Study 2014*.

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12. Source: Oliver Wyman, *The Next Chapter in Islamic Finance*.

13. IMF Working Paper, Maher Hasan and Jemma Dridi, *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study*, 2010.

14. Source: Malaysia International Islamic Finance Centre, *Global Islamic Fund Industry Growth Despite Challenging and Volatile Market*, 23 December 2013.



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