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SUKUK PERCEPTIONS & FORECAST STUDY 2017

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 #SUKUK2017

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Global Head Islamic Finance, Fitch Rating

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# Executive Summary



Thomson Reuters is pleased to present its fifth consecutive annual Sukuk Perceptions and Forecast Study. For 2017, we review a global sukuk market facing both widespread opportunities and particular and serious challenges. We complement our statistical and qualitative analysis from a range of perspectives with the opinions of market leaders in different segments from around the world. Our in-depth Sukuk Survey completes the picture, with responses from professionals on the sell and buy sides of the market.

## KEY HEADLINES

### **The decline in new issuances slows in 2016**

Sukuk issuance remained subdued in 2016 after reaching an all-time high by value in 2012 and by number of issuances in 2013. However, despite continuing challenges including low oil prices and the attraction of conventional bonds for potential issuers, the decline in new issuances in 2016 is on pace to be lower than that of 2015, while the total value of outstanding sukuk continued to grow.

### **Issuers shift toward quasi-sovereign entities, international currencies**

Although the value of new issuances declined by 18% year-on-year in the first nine months of 2016 to US\$39.82 billion, the market welcomed new issuers Ivory Coast at the end of 2015 and Togo this year, and maintained issuances from 13 different jurisdictions. By comparison, new issuances fell 51% in the similar time period last year, as compared to 2014. Malaysia remains the biggest domestic sukuk market with US\$23.14 billion in new issuances, followed by the UAE with US\$3.95 billion and Saudi Arabia with US\$3.20 billion.

Along with this slowing decline in issuances, the sukuk market has also witnessed a shift in some of its attributes. The proportion of sukuk denominated in domestic currencies has fallen to 56% of all new issuances, compared to 86% in 2012. Moreover, the share of quasi-sovereign entities as issuers of sukuk has increased from 23% to 31% year-on-year. Financial services remain the largest private sector in the market by far, issuing US\$14.2 billion in sukuk, while no other single sector issued more than \$3 billion in total in the first nine months of 2016.

Many of these shifts are attributable to the lasting effect of Bank Negara Malaysia's decision to stop issuing short-term sukuk in 2015 in exchange for targeted Islamic T-bills reserved for the liquidity management of Malaysian Islamic banks, as well as the expansion of state budget deficits in GCC countries because of lower export revenues resulting from low oil prices. Rather than turning to sukuk as some analysts had presumed, these sovereigns have preferred issuing conventional bonds based on their relative simplicity and low costs.

### **Supply still falls short of demand in the global perspective**

Large institutions hold the majority of sukuk issued worldwide until their maturity. The majority of investors in our survey therefore believe that improving the secondary market for sukuk is key to attracting issuers and lowering costs, but this requires a boost to the limited supply, posing a cyclical trap. Moreover, smaller corporations face less investor appetite than sovereigns for their sukuk, as well as high relative costs associated with arranging and rating small issuances. However, these shortages are both reducing the demand for a high credit rating, and moving preferences from short to longer-term tenors.

In spite of these shortages, the largest segment of our survey respondents indicated they were willing to invest between 5% and 25% of their portfolios in sukuk, with a further 44% willing to invest more than 25%. Investors are eager for new issuances from promising emerging sukuk markets such as the United States, Australia and Hong Kong.

### **The outlook for 2017**

2016 provided a fair share of economic and political shocks, although the core countries of the Islamic finance industry have largely come to terms with persistent low oil prices, while the full scope of expected global interest rate hikes failed to materialize. While the "Brexit" process has the potential for short-term economic disruption as the UK renegotiates relationships with its trading partners, it could turn to sukuk to address new financing shortfalls resulting from a loss of EU budgetary funding during this transition.

The pipeline of announced and rumored sukuk as of September 2016 totals US\$22 billion, down from US\$32 billion a year prior. However, qualitative factors have promising signs for the recovery and expansion of the sukuk market in the coming year. Since the lifting of UN sanctions on Iran in January 2016, its government is preparing to attract international investors to a potentially increased volume of sukuk. Oman, Nigeria, and Kenya have recently issued new sukuk regulations, while the latter two and Niger are all planning to issue their first sovereign sukuk in the near future.

## GLOBAL SUKUK MARKET UP TO Q3 2016



### Sukuk Issuance by Region



13

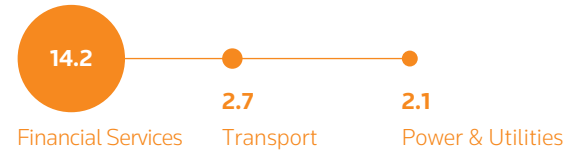
Jurisdictions tapped sukuk market by Q3 2016

USA is the most preferred emerging sukuk market for investors

UAE remains the most preferred country to issue and invest in sukuk

Hong Kong is the most preferred emerging sukuk market for issuers

### Top Sukuk Issuance by Corporate Sectors (US\$ Bn)

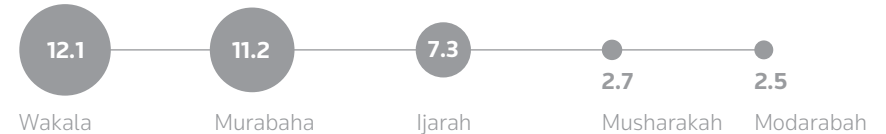


### Sukuk by Issuer Type (US\$ Bn)



Sovereign and financial services are the most preferred sectors for sukuk market players

### Sukuk Issuance by Structure (US\$ Bn)



### Sukuk Issuance by Market Type

Market shifted towards international sukuk according to our sukuk survey. This was met with a more preference towards international lead arrangers.

#### By currency

US dollar overtook Malaysian ringgit in terms of sukuk issuance. US dollar is still the most preferred denomination for sukuk.

#### By tenor

Market preference shifted towards long term sukuk because of lower supply.



## Sukuk Issuers

**Sukuk is the most preferred debt refinancing option for issuers despite the drop in sukuk volume**

# 71%

Issue sukuk to diversify sources of funding.

### Challenges



An active secondary market is necessary to make sukuk more appealing. Limited sukuk supply is the main reason for the lack of liquidity and tradability.



The drop in oil prices is considered the main reason for sukuk market volatility.



Most issuers feel that small corporate issuers' size is the main hurdle for issuing sukuk.



## Sukuk Investors

**Diversification leads main reasons to invest in sukuk**



Most investors will allocate **5-25%** of their Islamic assets to sukuk.



**Over half of buy-side respondents still prefer to allocate to sukuk amounts less than**

# US\$ 25 Mn

## Beyond 2016

**Announced and rumored sukuk pipeline up to September 2016 adds up to US\$22 billion**

### Survey Findings

Survey respondents estimate that the level of sukuk issuances for 2016 will exceed

# US\$50 Bn

Survey respondents are optimistic about 2017, expecting sukuk issuances will reach

# US\$75 Bn

### Sukuk Supply and Demand Model

Projected size of sukuk issuances in 2021 at

# US\$78.5 Bn



**Most of the sukuk pipeline comes from the GCC, mostly from financial services sector.**



**New players from Africa are willing to tap into the sukuk market such as Kenya, Niger and Nigeria.**

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ISLAMIC FINANCE DEVELOPMENT INDICATOR (IFDI) 2016

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for IFDI Model and Report

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## CHAPTER 1

# Global Market Overview

Early morning fog  
is covering Dubai  
business bay area.



## Impact of Global Economic Events

### Fixed income prospects to save Middle East from economic headwinds

#### Slump in oil prices

Oil prices remain at consistently low levels since plummeting in 2014. Since oil revenues account for up to 75% of GCC governments' revenues, state budgets have shifted from high surpluses earlier in the decade to high deficits (estimated by S&P at US\$150 billion for 2016). This has led them in recent years to turn to debt markets, and rely heavily on debt issuances to fund these budget deficits. Qatar has stated its intention to fund almost its entire deficit through new debt issuances; it sold US\$9 billion of Eurobonds in May 2016, across three maturities (5, 10, and 30 years), considered one of the Middle East's largest bond issuances. Saudi Arabia is expected to be the biggest issuer of sovereign debt to fund its deficit valued at approximately US\$98 billion. It issued its first international bond of a record US\$17.5 billion in October 2016. Emirates NBD estimates that GCC debt will reach US\$112 billion by the end of 2016, with 50% covered by sovereign issuances.



SAUDI ARABIA IS EXPECTED TO BE THE BIGGEST ISSUER OF SOVEREIGN DEBT TO FUND ITS DEFICIT VALUED AT APPROXIMATELY US\$ 98 BILLION. IT ISSUED ITS FIRST INTERNATIONAL BOND OF A RECORD US\$ 17.5 BILLION IN OCTOBER 2016.

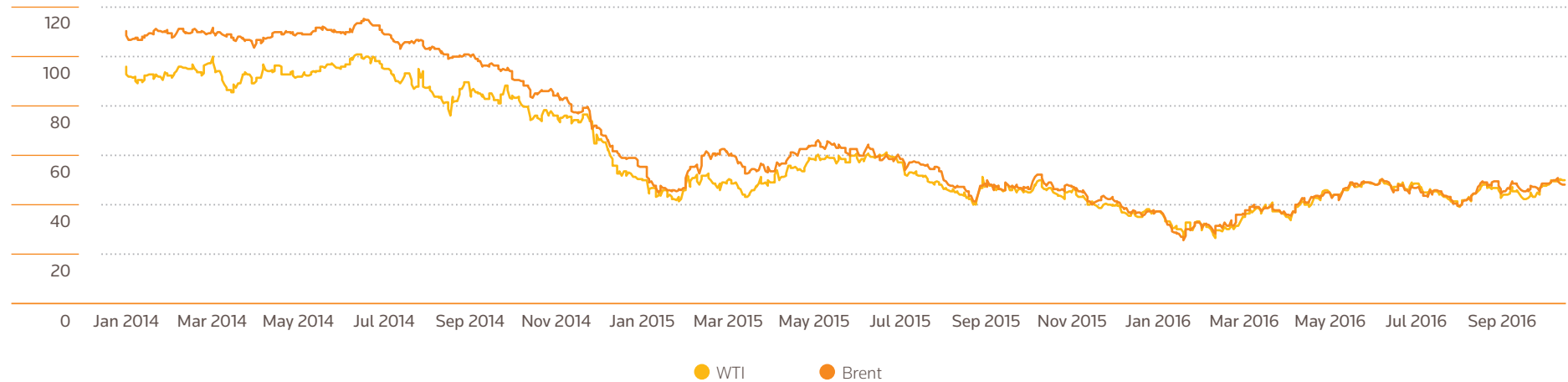
#### Debt issuance and subsidy cuts will continue to fund GCC deficits in the short term

Policy responses to low oil prices have led to spending cuts across the GCC, which include cuts to government subsidies. GCC governments have headed in this direction in an attempt to create savings and build down their budget deficits, but also to redirect governments toward non-oil sectors. Bahrain estimated that it would save approximately US\$1.6 billion by 2019 by making subsidy cuts; however this amount would only cover half of its 2016 deficit. As the savings from these cuts will begin to materialize in the medium-term, it is likely that governments will ramp up their issuances in the short term. Moreover, as these savings are never likely to cover a very large proportion of GCC sovereigns' cumulative funding needs of US\$560 billion from 2015 to 2019 (S&P estimate), conditions are good for fixed income markets in the region to continue growing.

#### IMF PROJECTIONS FOR GCC GDP GROWTH AND FISCAL DEFICIT (AS % OF GDP)

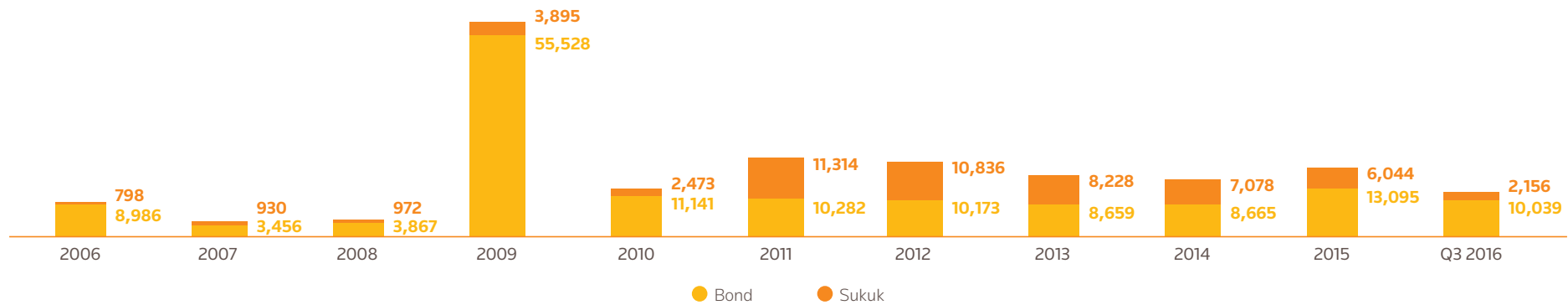
	2013	2014	2015	2016f	2017f
Annual growth (real GDP)	3.2%	3.5%	3.3%	1.8%	2.3%
Fiscal balance	10.2%	3.30%	-9.90%	-12.3%	-10.8%

### OIL PRICES (US\$)



Source: Thomson Reuters

### GCC SOVEREIGN DEBT ISSUANCE (US\$ MILLION)



Source: Thomson Reuters

### **Saudi's Vision 2030: new opportunities for sukuk**

Saudi Arabia's reform plan, Vision 2030, came as a policy response to the significant decline in oil prices since last year. The plan was designed to free the Saudi economy from its dependence on oil revenue by increasing non-oil government revenue to SR1 trillion (US\$267 billion). HSBC has estimated the financial requirements for all proposed projects in the plan will cost US\$75 billion per year, which is likely beyond the capacity of the Saudi banking sector. Vision 2030 includes initiatives to develop the Saudi capital markets as a source of long-term funding for these projects, with volumes expected to grow to SR94 billion by 2030 from SR21 billion in Q2 2015.

### **Iran's return to global markets: A boost for sukuk market and new diversification opportunities**

Earlier this year, the majority of sanctions imposed on Iran by the UN, the EU and the US were lifted, potentially restoring its access to global financial markets. Although Iranian companies remain restricted from raising capital in Western markets, Iran has attracted interest from investors in Islamic financial markets looking to diversify through exposure to its growing economy, which has become less reliant on oil. It is anticipated that the country's infrastructure development program for the next decade will require foreign funding worth US\$1 trillion. As Iran's financial system is fully Shariah-compliant, these projects will provide a significant boost to the global Islamic finance market, specifically in terms of sukuk. Tehran-based analysts estimate that there are already around 180 Iranian companies from key sectors, including manufacturing, hospitality, and transport, that have been considering issuing sukuk in 2017.

### **Sukuk markets remain resilient amidst political instability in MENA region**

The MENA region has been experiencing heightened political instability since 2011, currently concentrated in Syria, Iraq, Libya and Yemen. Political transitions are undergoing in Egypt, Tunisia, Morocco and Jordan, among other countries, which face security concerns over growth-oriented economic policies. The World Bank estimated that MENA economic growth will be 2.9% in 2016, increasing to 3.5% in 2017 and 3.6% in 2018. Economic instability has been most evident in the countries that have been affected the most by insurgencies and warfare, with government securities yields spiking and short-term investors withdrawing from the market. The Islamic Development Bank (IDB) is planning to issue sukuk, possibly in partnership with the World Bank, to finance refugee programs and reconstruction in these countries, with Yemen as its top priority. The economic slowdown experienced by countries in political transition has seen their budget deficits widen, increasing their financing needs. This has led their governments to consider further debt issuances, steering towards sukuk as an alternative for raising foreign funding for their development projects and budget deficits.





^  
A trader looks at his screen in the crude oil and natural gas options pit on the floor of the New York Mercantile Exchange. REUTERS/Lucas Jackson



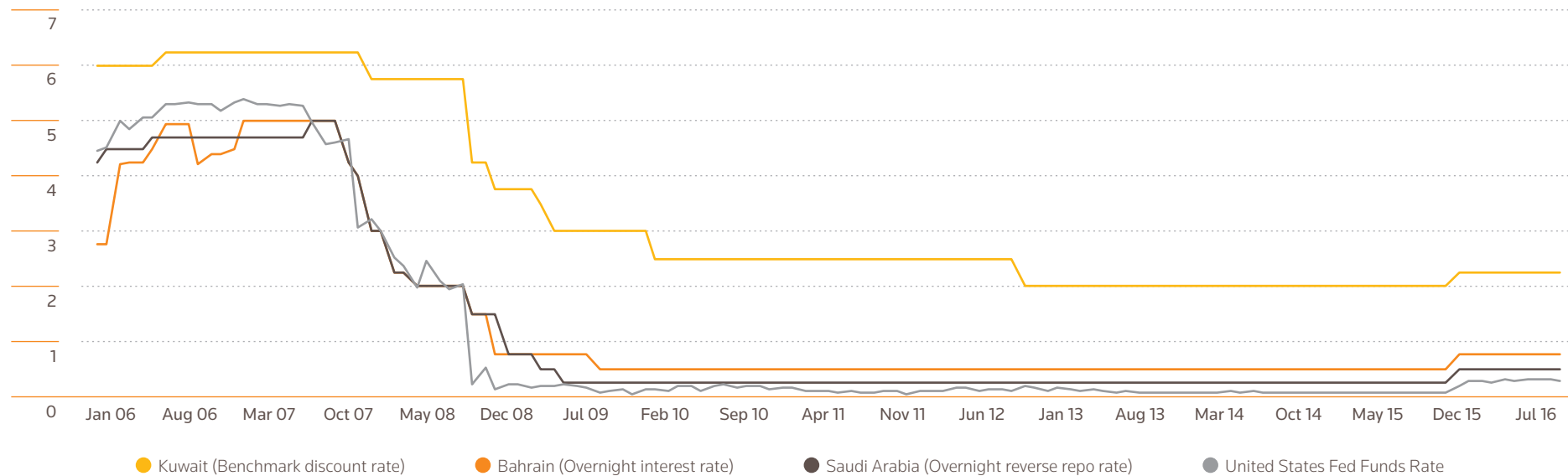
## The impact of interest rate hikes on sukuk and bonds

### Anticipation of Fed rate hike reduced issuer appetite for fixed income

After much anticipation throughout 2015, the Federal Reserve hiked the US interest rate for the first time since 2006 to 0.5% after the benchmark rate remained near zero for seven years. Soon after, Saudi Arabia (overnight reverse repo), Kuwait (benchmark discount rate) and Bahrain (overnight interest rate) all raised their benchmark rates. The remaining GCC countries have opted to follow a wait and watch approach before affecting any rate increases. Concerns in the market throughout 2015 over a steep rise

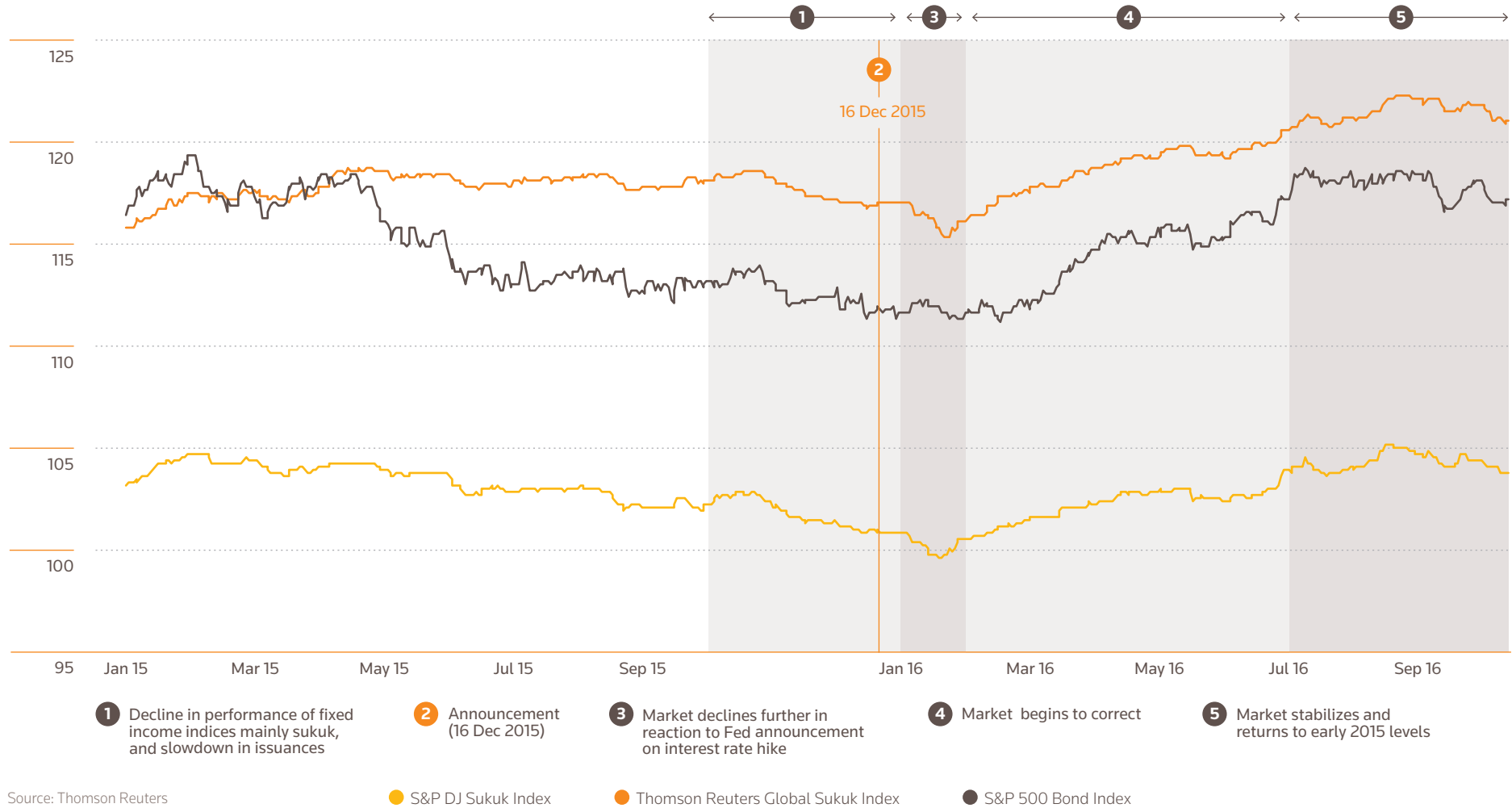
in interest rates had deterred issuers, which contributed to a slowdown in issuances. The performance of the market began to deteriorate in Q4 2015, and as investors began to sell off their fixed income investments when the rate hike was announced, the market dropped slightly and then began to correct. The rate hike had already been priced into the sukuk market before it happened, containing the sudden reaction to the decision.

GCC POLICY RATES VS. US FED FUNDS RATE (%)



Source: Thomson Reuters

PERFORMANCE OF GLOBAL SUKUK AND BOND INDICES



Source: Thomson Reuters



**BASHAR AL NATOOR** is Fitch Rating's Global Head Islamic Finance. Mr Al Natoon is responsible for coordinating all Islamic Finance activities across Fitch's Sovereign, Financial Institutions, Corporate, Structured Finance, Infrastructure and Insurance teams, bringing together dedicated analytical and industry expertise into a centralised and focused Islamic finance group. Mr Al Natoon has more than 14 years' experience in the Islamic Finance market. Since joining Fitch in 2007, he has overseen Fitch's Sukuk criteria and Islamic Finance practices, undertaken research and written numerous published articles on Islamic Finance.

# BASHAR AL NATOOR

Global Head Islamic Finance, Fitch Rating

## What are the driving factors for governments when choosing sukuk or bonds for their funding requirements?

There are a number of factors and circumstances governments consider when deciding whether to issue bonds or sukuk, or indeed, a combination of these instruments.

The first is the intended investor and funding base. This plays a big part in the decision to select a sukuk or a bond or both. The important variables are usually whether to issue sukuk (or bonds) domestically or internationally, using either local or foreign currency denomination. These two features are often interlinked, as many issuances are denominated in the currency of the market in which they are issued. If the target is predominantly international investors, bonds may be the preferred instrument, as international investors

are usually more familiar with bonds over sukuk. On the other hand, if local and regional investors are the target, and there is a significant presence of Islamic investors, then sukuk or both sukuk and bonds may be the preferred choice.

The second set of factors is the existence of a sukuk-supportive infrastructure and an Islamic finance strategy for the issuing sovereign. Both factors could pose significant challenges in the selection of bonds or sukuk. Of particular importance is the existence of an established legal framework that is acceptable to a government, investors and the Sharia boards, which is a prerequisite to issuing sukuk.

Third is the requirements and size of the Islamic finance industry in the country of issuance. As Islamic banks are not allowed to invest in traditional

bonds, the lack of high-quality liquid assets continues to be one of the key challenges Islamic banks face. Sovereign sukuk plays a big role in bridging this gap, and a sukuk could become a worthwhile option to help the Islamic finance industry overall.

## There has been a significant shift from sukuk to bonds in 2016 in the GCC. Why are bonds preferred by governments, especially during the current economic challenges?

We would not say there has been a significant shift from sukuk to bonds, since only Bahrain and Oman of all GCC countries have issued both sukuk and bonds at moderate levels in the past few years. However, in 2016 we have seen the return of Saudi Arabia, Abu Dhabi and Qatar to the sovereign international bond markets with issues of US\$17.5bn, US\$5bn and US\$9bn, respectively.

Indeed, at the emerging markets level, oil exporters in the Middle East are becoming an important source of the flow of international bond issuances. With oil prices reaching historical lows in February 2016, several governments turned to bond and sukuk markets for funding. According to the Bank for International Settlements, overall, Africa and the Middle East contributed 32% of total net issuance in EMs, close to the 37% contribution from emerging Asia-Pacific and 23% for Latin America as of 1H16. This is a new trend for such markets.

In 2016, we saw Bahrain, Oman, Qatar, Malaysia, Indonesia, Turkey and Pakistan (7 out of 10 key sukuk markets) also tapping the sukuk market, with other GCCs indicating that they would issue sukuk, or a mix, in the future.

**Despite the decline in sukuk issuance in matured markets, what are the prospects for non-OIC countries in considering sukuk?**

Fitch focuses on longer-term issuances (i.e. with maturity of more than 18 months), as frequently rolled-

over short-term debt could distort underlying trends, which significantly contributed to the drop in sukuk issuance in 2015.

With that in mind, total new sukuk issuance (with maturity of more than 18 months) in the GCC, Malaysia, Indonesia, Turkey and Pakistan, actually rose to around US\$22 billion in 1H16 from around US\$20 billion in 1H15, an increase of 11%.

Moreover, in 1H16, sukuk stood at 30% of total debt issuances in these markets, slightly ahead of its share in the same period a year ago. Notably, sukuk could not maintain its very strong market share in the first quarter because of the return of sovereign conventional bonds issued by GCC members in recent months.

Outside key markets, we still believe the short-to-medium-term prospects are limited, owing to challenges from a lack of standardization in the industry. This prevents the establishment of legal structures and legislation to accommodate the issuance of sukuk, and so structuring sukuk remains a relatively complex and time-

consuming process compared to issuing a traditional bond.

Two of the main challenges related to the complexity of sukuk are the lack of tax neutrality for sukuk and the ability to establish a special purpose vehicle (SPV) that usually acts as the issuer for the sukuk. Taxation is often challenging for sukuk because of their asset-backed/based nature. This structure requires several asset transfers in a sukuk transaction, creating a dense tax burden for issuers where there is not special sukuk legislation in place. Regulations often need to be amended to provide an exemption to taxable gains, such as on the transfer of assets and tax on rental income earned by a sukuk-issuing SPV. This is also true for withholding taxes linked to the transfer of underlying assets in sukuk transactions.

We have seen some growth outside the key markets in 2016. For example, we saw Jordan and countries in Africa issuing sukuk, which shows positive momentum. However, structural challenges remain. Reuters reported that in 2016, Togo's initial sukuk was XOF150 billion (US\$255 million).

This comes after Senegal launched its second XOF200 billion (US\$341.5 million) sukuk towards the end of June and Côte d'Ivoire's second phase of its XOF300 billion (US\$510 million) sukuk program.

**What is holding back corporations from issuing sukuk? Is structuring and issuance cost a hurdle? Are corporations (other than banks) simply too small to issue sukuk?**

There are numerous limitations and challenges in developing corporate bonds and sukuk alike, even in countries where sukuk is active, so this is not a sukuk-specific issue. However, sukuk has its own challenges, which means that time needed to tackle these obstacles could in turn lead to a longer time frame and potentially higher costs in relation to more conventional forms of funding, until a standardized sukuk framework is established.

Nevertheless, recent developments could encourage growth in the GCC corporate sukuk market. We have seen a return to debt issuance by the GCC governments. This provides the





yield on sovereign debt, which serves and creates a pricing benchmark from which all other debt instruments in the same market can be priced, which is an essential starting point. Lower oil prices affecting sovereign reserves, and in turn banks' lending appetite, so liquidity is also a factor. GCC corporations have been relying on bank lending as the primary source of funding, and liquidity pressure could drive the need for corporations to diversify their funding, which would reduce the cost difference between loans and sukuk or bonds for issuers.

Finally, the government encouragement and regulatory reforms could also make the capital market more attractive for the corporate sector.

Notably, GCC corporations would be more likely to issue sukuk than bonds (or use both) in order to attract a wider local and regional investor base (i.e. including Islamic investors, in the case of sukuk). Some corporations are also limited to only Shariah-compliant borrowing by their own rules or as a result of being included in Islamic investment funds and indexes.

### **What does the sukuk secondary market look like after the drop in global sukuk issuances, and is Malaysia still as liquid as it used to be?**

The decision by Bank Negara Malaysia (BNM) in 2015 to stop offering short-term sukuk had a far-reaching impact beyond the reduction of total sukuk issuance volumes. It also impacted some global Islamic banks that were used to investing their liquidity in BNM short-term sukuk. BNM has provided other liquidity tools for its market, including the recent central bank Islamic T-bills launched early this year, adding to a range of liquidity management tools for the Malaysian Islamic banking industry.

The sukuk secondary market is interlinked with the growth of the sukuk market in general. Whether or not it will change the sukuk investors' typical "buy and hold" attitude remains the key challenge for the sukuk secondary market. This challenge is coupled with the underdeveloped capital markets (including secondary markets for bonds and sukuk alike) in the GCC and other active sukuk markets.

### **What are key challenges and developments facing the sukuk market? What is the outlook for sukuk?**

Sukuk does not operate in isolation from specific country, regional or global factors driving capital markets and national economies. Noting these general trends, the sukuk industry has a few extra challenges.

We will focus on two developments impacting sukuk market growth rate. Firstly, product-specific challenges in regulation, standardization and sukuk wider acceptance. Secondly, the development of capital markets as a whole in the GCC.

Recent regulatory improvements could help speed up the sukuk harmonization process and reduce costs. The Saudi Capital Market Authority's reform of the corporate debt market has included measures to make regulatory approval of debt products easier. Kuwait's Capital Markets Authority announced a broad sukuk framework in November 2015 and Oman has recently updated its sukuk regulation. The central bank of the UAE proposed

creating a Higher Shariah Authority to provide unified supervision and guidelines on Islamic finance-related matters. Other regional bodies are also contributing to this key challenge by introducing standards and principals that could also aid this process.

Sukuk harmonization initiatives, in combination with GCC funding needs and a return to capital markets, efforts to improve capital markets, improving regulatory environments and developments cited earlier in this report, support our expectation that sukuk issuance will increase gradually over the medium to long-term, in key and emerging sukuk market countries.



## CHAPTER 2

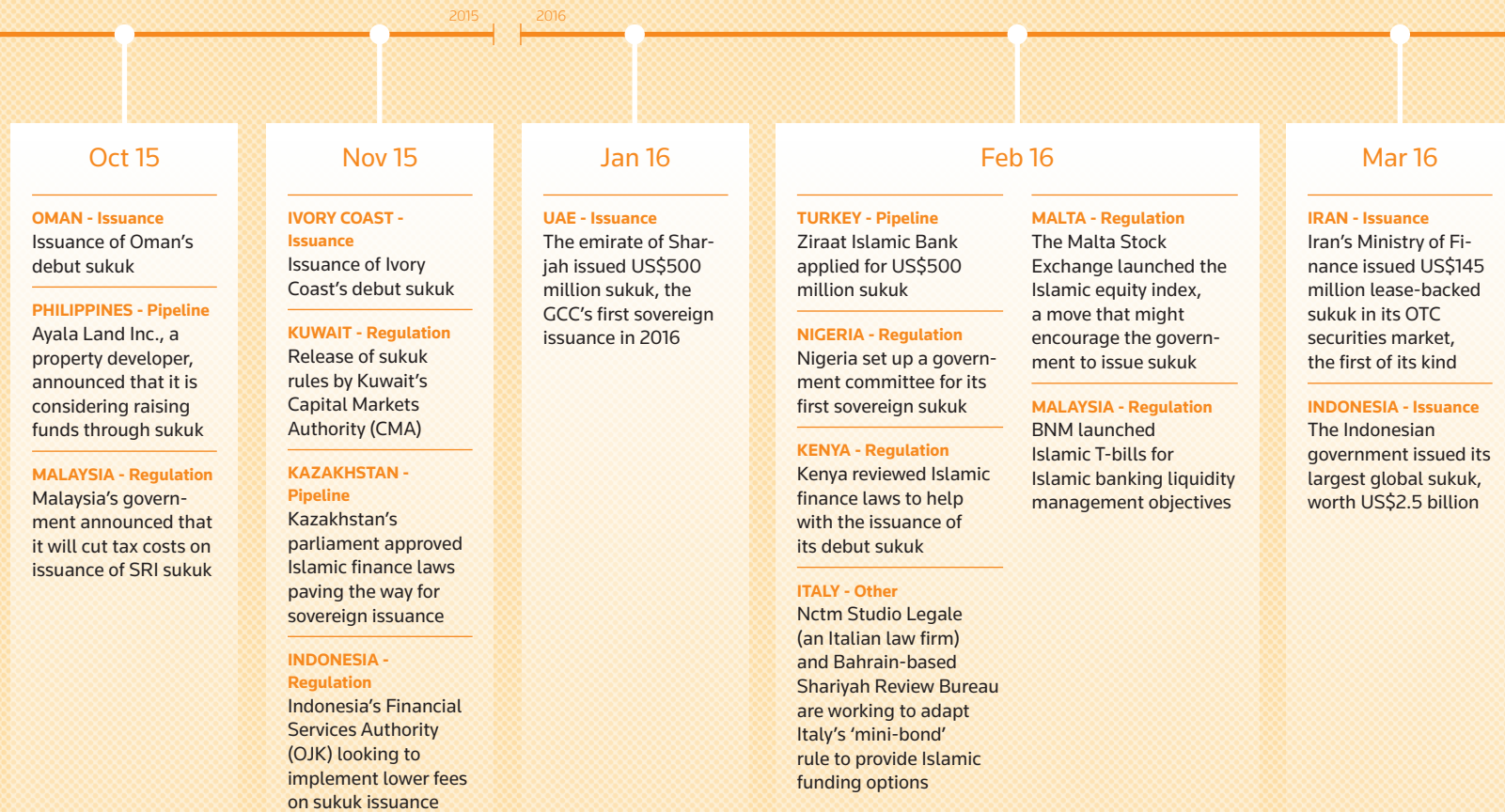
# Global Sukuk Market Outlook

Malaysia's landmark  
in the capital  
Kuala Lumpur.





# Key Milestones (Q3 2015 – Q3 2016)



Apr 16

**PAKISTAN - Issuance**  
Pakistani banks arranged US\$955 million sukuk for a hydropower plant, the country's largest infrastructure deal

**SAUDI ARABIA - Pipeline**  
Saudi Aramco approved its sukuk funding initiative

**USA - Pipeline**  
University Bank plans a debut sale of sukuk

**KUWAIT - Pipeline**  
Kuwait's government plans to issue US\$6.6 billion worth of bonds including sukuk

May 16

**OMAN - Regulation**  
Oman second corporate sukuk, MB Holding's US\$150 million, got approved by the regulator

Jul 16

**TOGO - Issuance**  
Issuance of Togo's first US\$251 10-year sukuk

Aug 16

**IVORY COAST - Issuance**  
Ivory Coast sold its second 7-year sovereign sukuk

**MALAYSIA - Regulation**  
Malaysia's new central bank governor cuts sukuk rates unexpectedly

**NIGERIA - Pipeline**  
Nigeria's Securities Exchange and Commission (SEC) announced that sovereign sukuk will be issued in Q1 2017

**QATAR - Issuance**  
Qatar issued first domestic sukuk for the year signaling easing of liquidity conditions in the market

**UAE - Other**  
Fitch updated its criteria for rating sukuk

**MALAYSIA - Issuance**  
IILM auctioned first four-month tenor sukuk

**USA - Other**  
JP Morgan added sukuk to its emerging market indices

**INDONESIA - Issuance**  
Indonesian government issued first ever 'savings sukuk' to retail investors

Sep 16

**PAKISTAN - Regulation**  
Pakistan's Federal Board of Revenue granted tax neutrality for sukuk, a similar treatment to conventional bonds

Oct 16

**JORDAN - Issuance**  
Jordan issues its first local currency sovereign sukuk

## 2015 Recap: Industry at Crossroads

The ICD (Islamic Corporation for the Development of the Private Sector) Thomson Reuters Islamic Finance Development Indicator is a composite weighted index that measures the overall development of the Islamic Finance industry by providing an aggregate assessment of the performance of all its parts, in line with the objectives of Islamic principles. It takes into consideration five indicators: Quantitative Development (QD), Knowledge, Governance, Corporate Social Responsibility (CSR) and Awareness.

The **sukuk sub-indicator** value, part of QD, is the outcome of seven metrics: number of sukuk issued and outstanding, volume of sukuk issued and outstanding, number of listed sukuk, number of rated sukuk and the bid/ask spread for each country within the IFDI universe. These are normalized, and then averaged to reach to the global sub-indicator value. More on IFDI's background insights can be viewed at <http://www.zawya.com/islamic-finance-development-indicator/>

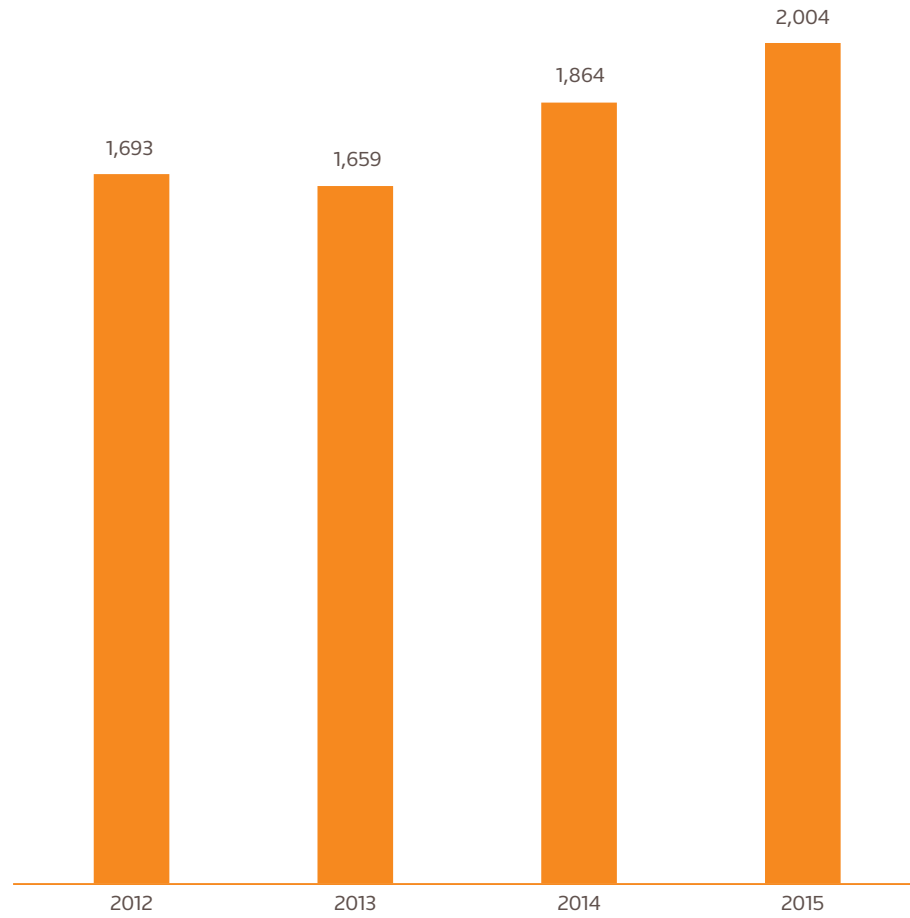
### Despite uncertainty due to the economic slowdown, sukuk growth remained strong in 2015

According to the ICD-Thomson Reuters Islamic Finance Development Indicator (IFDI), net global Islamic finance assets reached US\$2 trillion in 2015. Worldwide, Islamic finance assets have had a CAGR (compound annual growth rate) of 4% since 2012 and capital market asset classes remain the fastest growing of all Islamic finance assets. Sukuk remains the second-fastest-growing asset class, with a CAGR of 7% since 2012.

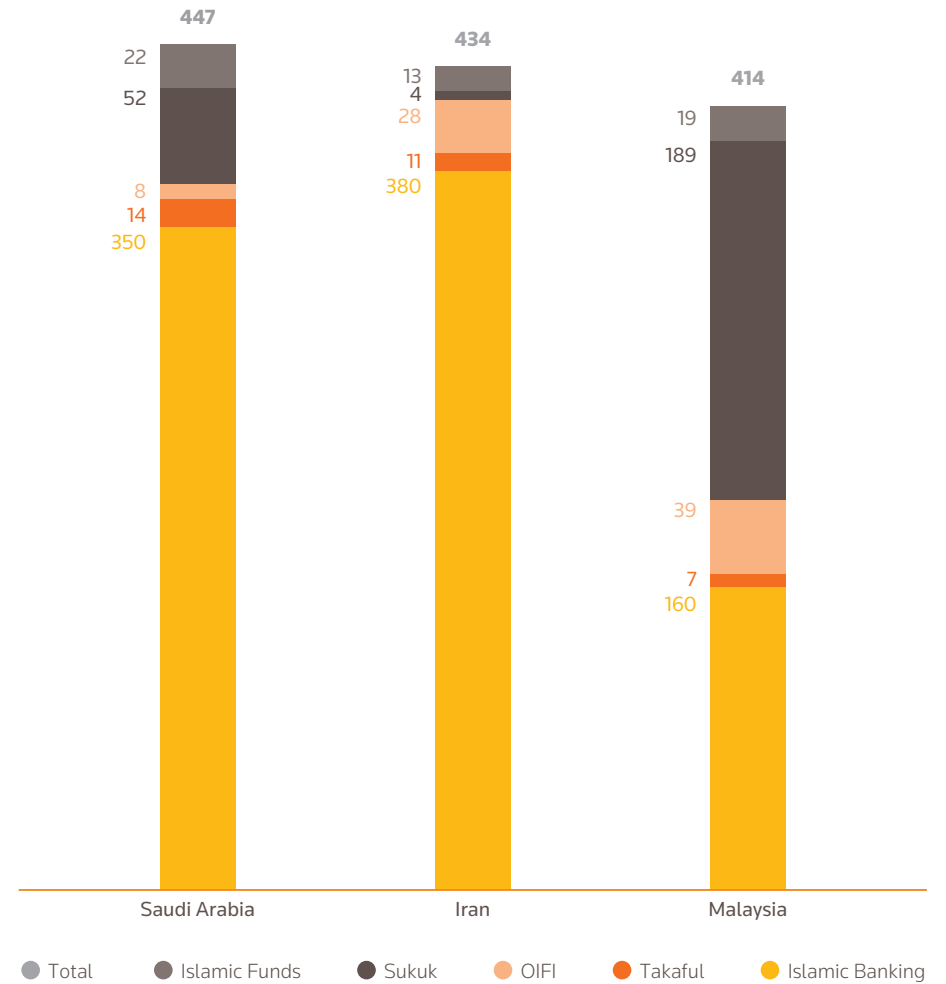
Breaking down Islamic finance assets by sector, Islamic banking is the biggest by a large margin, with assets totaling US\$1,451 billion or (73%). Sukuk is the second largest asset class at 17% of total assets.

By country, Saudi Arabia held the greatest value of Islamic finance assets in 2015, followed by Iran and Malaysia. Together they controlled 65% of Islamic finance assets globally and they were the only countries with assets greater than US\$400 billion in 2015. Sukuk represents a much larger share of Malaysia's Islamic finance assets (46%) compared to Saudi Arabia (12%) and Iran (1%).

### GROWTH OF ISLAMIC FINANCE ASSETS (US\$ BILLION)



### TOP 3 COUNTRIES IN ISLAMIC FINANCE ASSETS (US\$ BILLION, FYE 2015)



Source: Thomson Reuters



## Compared to other Islamic finance sectors and asset classes, sukuk had the most resilient performance

Although it is not the largest segment of the Islamic finance industry, the sukuk sub-indicator showed the strongest development in 2015 of all segments and asset classes. All of the Quantitative Development sub-indicators (Islamic banking, takaful, sukuk, Islamic funds and other Islamic financial institutions) declined in their development in IFDI, but sukuk had the smallest decline, making it the most resilient asset class. The decline in global oil prices and currency devaluation took a toll on the core Islamic finance markets' different asset classes and sectors.

While different Islamic finance assets grew in 2015, they witnessed diminished performance, as indicated by declined return on assets (ROA) and return on equity (ROE) for Islamic financial institutions and the lower cumulative performance of Islamic funds. The IFDI measures the performance of sukuk using the bid/ask spread which was not as negatively affected as the other sectors.

Total Global Sukuk Outstanding in 2015: **US\$309.8 Billion**

Total Global Sukuk Issued in 2015: **US\$65 Billion**

## Malaysia continued to keep the sukuk market active despite its declining contribution

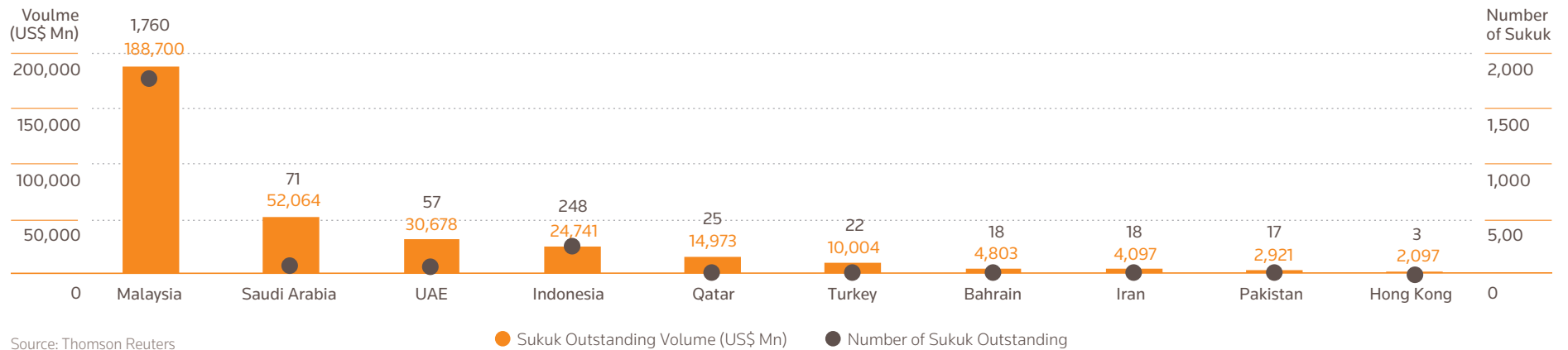
Malaysia remains at the forefront in terms of the number and volume of sukuk issued and outstanding in 2015. However, its global share of sukuk is declining from previous years as a result of policy decisions at Malaysia's central bank, Bank Negara Malaysia (BNM). BNM decided that it would cut back on short-term sukuk issuance, which it said was not fulfilling the country's Islamic banking liquidity needs. It decided to create different instruments specifically for Islamic banks, as a much wider investor base gradually dominated the market for sukuk. BNM launched its Islamic treasury bills in February 2016 in order to meet its liquidity objective.

Malaysia and Indonesia, the world's second largest market in terms of sukuk issuance, together made Southeast Asia the overwhelming leader of world sukuk issuances by region in 2015 (65%). GCC countries also have a large share globally in terms of sukuk issued (28%) and sukuk outstanding (31%).

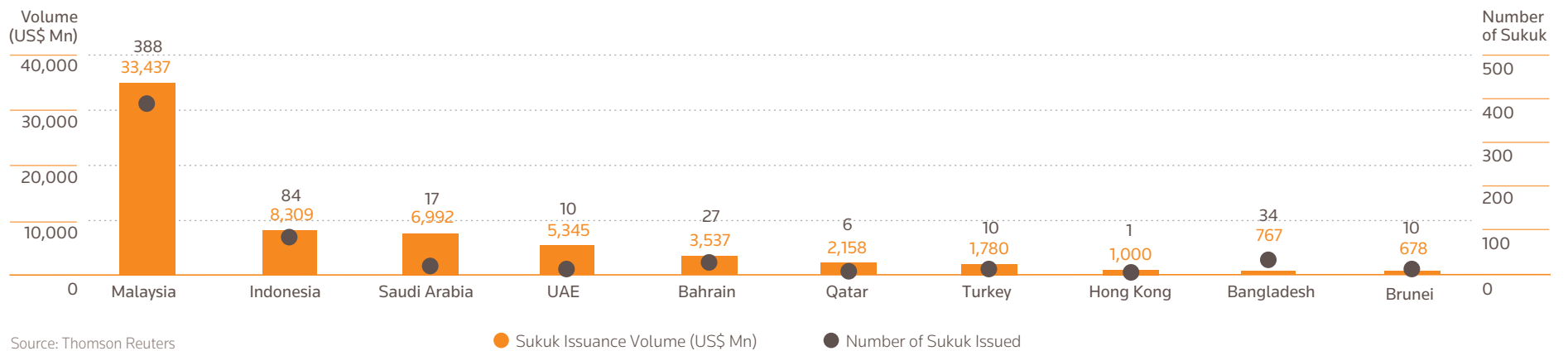


**MALAYSIA'S GLOBAL SHARE OF SUKUK IS DECLINING FROM PREVIOUS YEARS AS A RESULT OF POLICY DECISIONS AT MALAYSIA'S CENTRAL BANK.**

TOP 10 COUNTRIES IN SUKUK VOLUME OUTSTANDING (US\$ MILLION, FYE 2015)



TOP 10 COUNTRIES IN SUKUK VOLUME ISSUED (US\$ MILLION, FYE 2015)



## Sukuk Market 2016 Overview

### Sukuk Volume

#### Sukuk supply continues to drop as issuers find alternative funding options

Total sukuk issuances continued to drop in the first nine months of 2016. This was a result of the considerable fall in GCC sovereign issuances, as governments are increasingly turning to other funding instruments, such as conventional bonds, to fund their budget deficits. Issuances fell by 18.4% to US\$39.8 billion from US\$48.8 billion by Q3 in 2015. However, despite the total value of issuances falling for a second consecutive year, the sukuk market decline has significantly slowed from the 50.8% drop in issuances seen in 2015. In 2016, the sukuk market remains unlikely to surpass 2015 total issuances of US\$65.4 billion.

Following trends from 2015, the sukuk market remained quiet in 2016 mainly because of the low sukuk issuances in core markets of Malaysia and the GCC countries. In 2016, debt capital markets witnessed a shift by GCC governments away from sukuk in favor of conventional bonds. This occurred despite expectations that continuing low oil prices would push GCC states to capitalize on widespread demand for sukuk to raise funding for development projects and to address budget deficits.

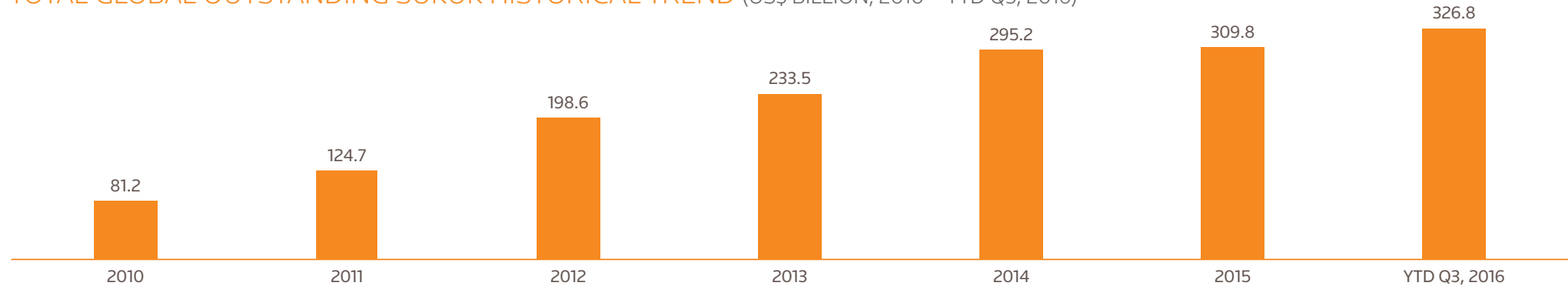
Lower issuance levels in Malaysia, the largest sukuk market globally, resulted from a Bank Negara Malaysia (BNM) decision in 2015 to cease issuances of short-term sukuk, as this instrument was not achieving its purpose of providing liquidity to the local Islamic banking system.

The sukuk market in 2014 was one of the better years in sukuk history for outreach and investor acceptance. A number of non-Muslim and non-traditional issuers tapped the market for the first time, such as the UK, Senegal, Maldives and South Africa. However, these issuers have not returned since. The only new issuers in 2016 were the Togolese and Jordanian governments, which issued their debut sukuk of US\$251 million in July 2016 and US\$47.9 million in October 2016, respectively. Moreover, recent first-time issuer Ivory Coast returned to the market with a second sukuk issuance in August 2016.

#### GLOBAL SUKUK GROWTH FOR THE FIRST NINE MONTHS (2010-2016)

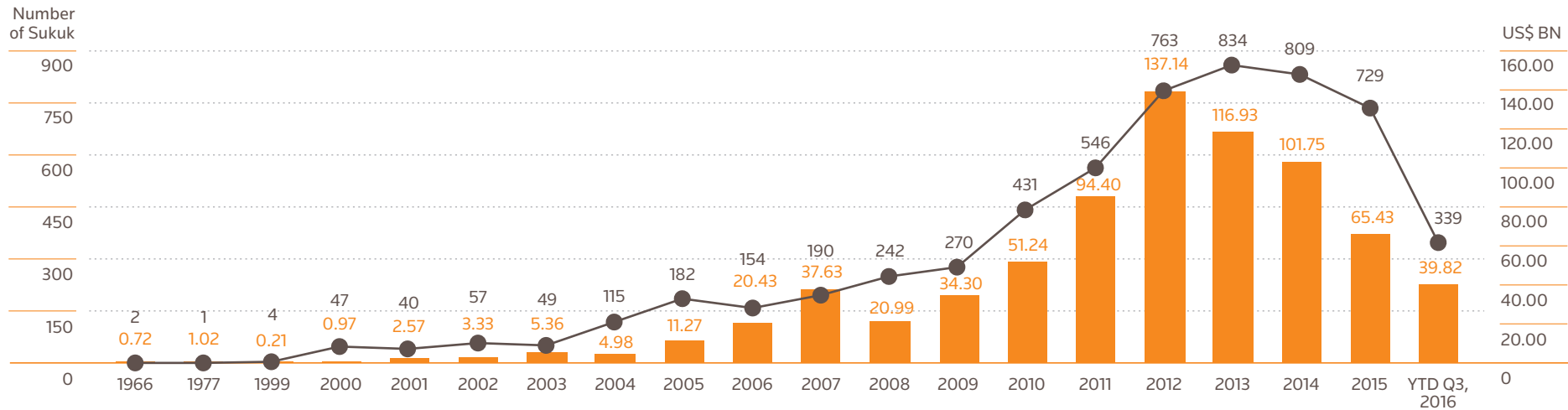
Period	Sukuk Amount (US\$ Billion)	Growth Rate
YTD Q3, 2016	\$39.8	-18.44%
YTD Q3, 2015	\$48.8	-50.82%
YTD Q3, 2014	\$99.3	24.50%
YTD Q3, 2013	\$79.7	-26.80%
YTD Q3, 2012	\$109.0	68.40%
YTD Q3, 2011	\$64.7	48.40%
YTD Q3, 2010	\$33.4	Base Year

TOTAL GLOBAL OUTSTANDING SUKUK HISTORICAL TREND (US\$ BILLION, 2010 – YTD Q3, 2016)



Source: Thomson Reuters

GLOBAL SUKUK ISSUANCE HISTORICAL TREND (1996-YTD Q3 2016)



Source: Thomson Reuters

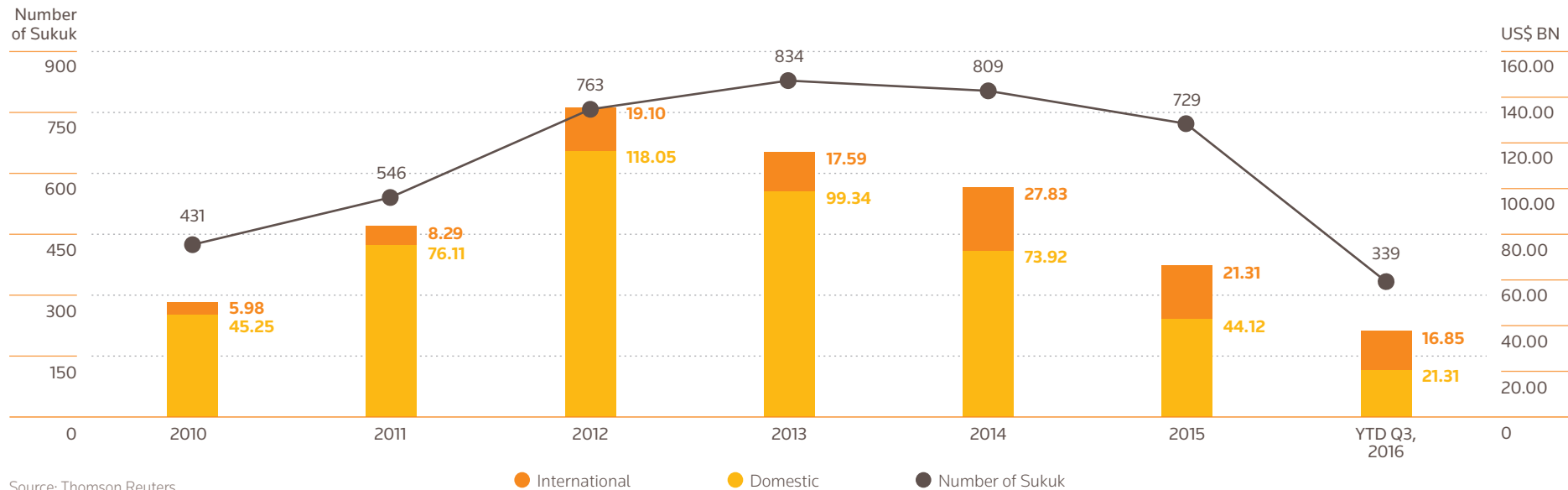
## Market Type

### 2016 has seen far lower domestic sukuk issuance

Sukuk issued in domestic currencies amounted to US\$21.31 billion by Q3 2016, only roughly half of 2015's full year value. Its share of total sukuk decreased to 56% by end of Q3 2016 from 66% in 2015. Like its precursors, the biggest issuer of domestic sukuk is Malaysia, with both government and corporations actively participating in the market. The Malaysian government is the biggest issuer with US\$6 billion issued by Q3 2016. Power and utilities is the biggest corporate domestic sector in Malaysia with US\$2.3 billion issued by Q3 2016. This is in line with the country's recalibration of its 2016 budget, which includes major infrastructure projects such as Mass Rapid Transit (MRT).

Although the international sukuk market, representing sukuk issued in USD, grew in its share of total sukuk issued from 34% in 2015 to 44% in YTD Q3 2016, its issued volumes decreased to US\$16.85 billion in 2016 from US\$17.38 billion in YTD Q3 2015. The biggest contributor by sector for international sukuk is financial institutions, with US\$11 billion issued in the first nine months of 2016, followed by sovereign issuances with US\$3.8 billion in 2016. International sukuk issuances reached a peak in 2014 when several new sovereigns issued sukuk for the first time, including Luxembourg, Hong Kong and the United Kingdom.

### GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY MARKET OF ISSUANCE (2010 – YTD Q3 2016)





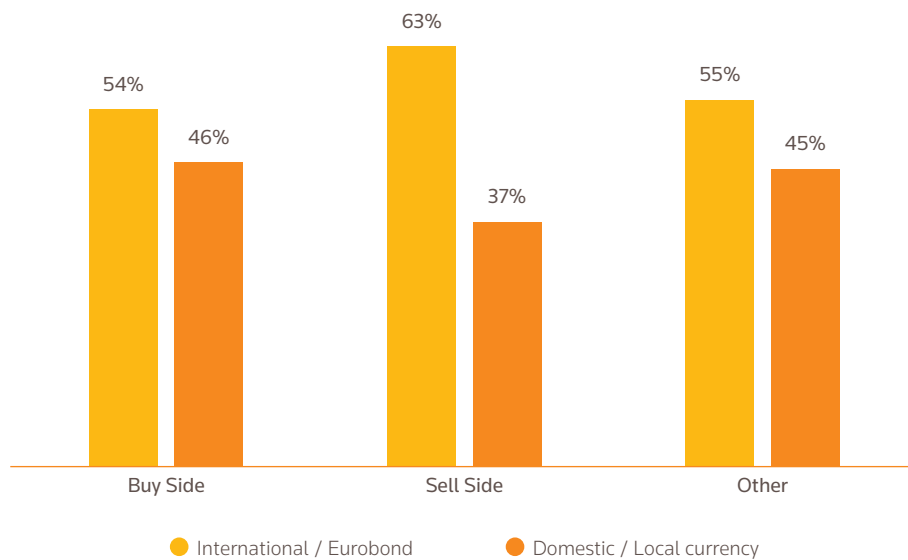
### A shift in preference towards international sukuk

Our sukuk survey finds that all market players prefer investing in international sukuk over domestic sukuk because international sukuk denominated in or pegged to USD essentially eliminate currency risk. This is a contrast to last year’s survey results, in which market players preferred domestic markets 53% to 47%, because they said local currencies are cheaper to hedge and quicker to issue.

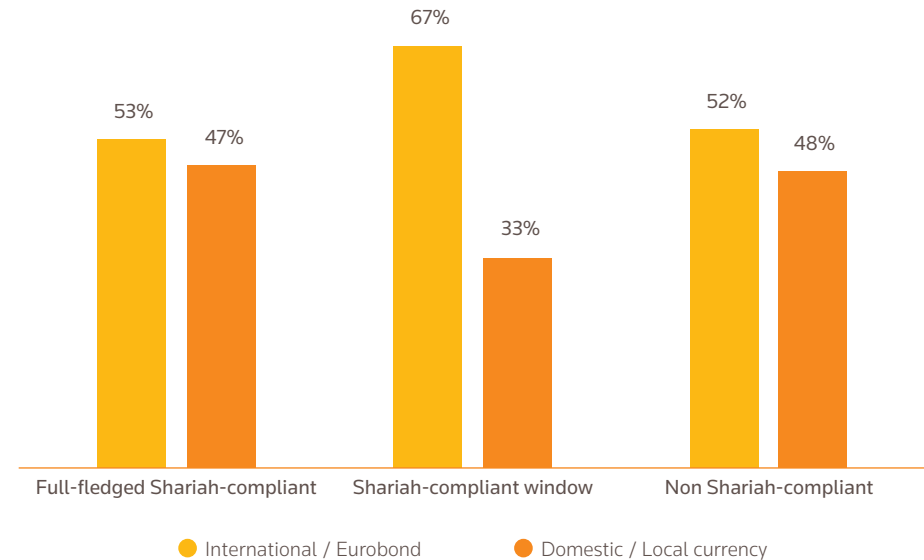
The decline in liquidity of the sukuk market, especially in Malaysia after its government stopped offering short-term issuances, is making international issuances more attractive for investors that need to find alternative markets for sukuk investments.

The international sukuk market could also benefit from developments in Euro monetary policy. The European Central Bank’s quantitative easing program means that many European investors will be looking for higher returns in emerging markets. Investors could benefit from sukuk investments’ better returns in these markets. Meanwhile, issuers could capture institutional investor demand for international and emerging market issuances, especially from those with a full Shariah-compliance mandate.

### SURVEY FINDINGS – TYPE OF ISSUE PREFERENCE



### TYPE OF ISSUE PREFERENCE BY SHARIAH MANDATE



## Region and Country

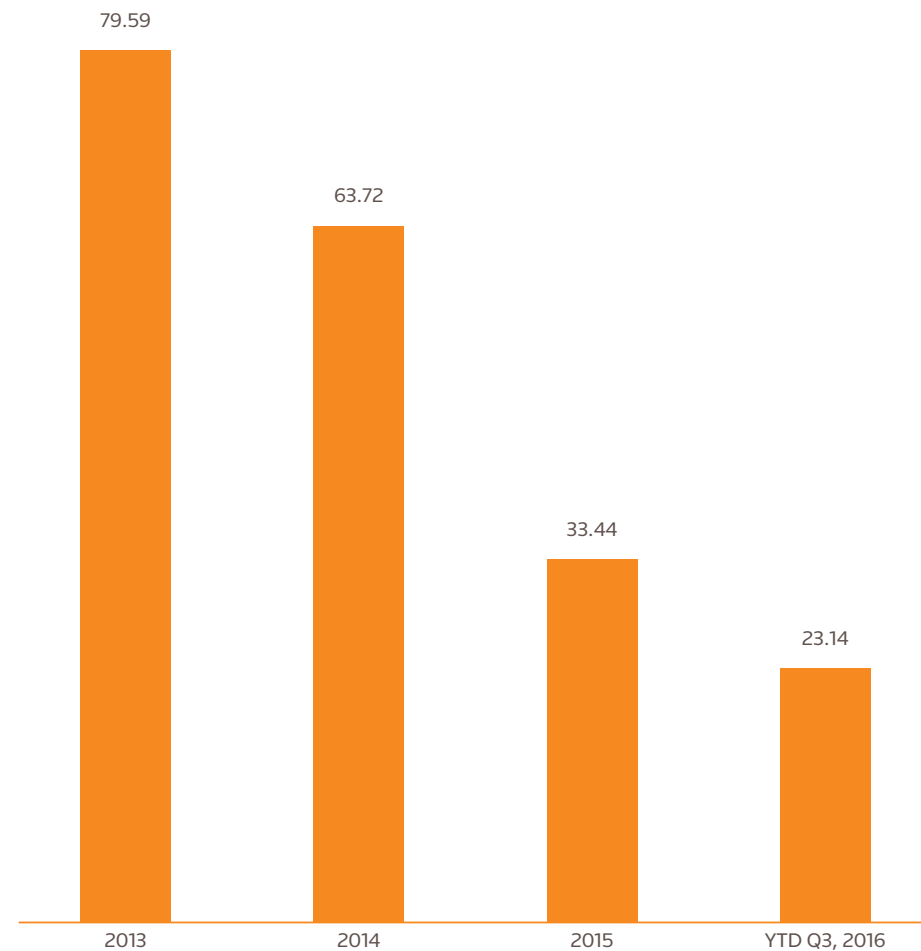
### The number of countries tapping the sukuk market remains at par for 2016

Sukuk was issued in 13 different jurisdictions in the first nine months of 2016, the same as YTD Q3 2015. By the end of 2015, the number of jurisdictions increased to 15 countries, with a new African nation issuer Ivory Coast along with Oman Sovereign Sukuk. Other Sub-Saharan African nations also tapped the market in 2016 with Senegal, Togo and Ivory Coast having sovereign issuances. For Senegal and Ivory Coast, it was their sophomore sovereign issuances, after the success of their debuts. Meanwhile, Togo added to the growing appeal of sukuk market as an alternative funding option for African states in 2016 when it issued its debut sukuk in August 2016. This has opened doors for other African countries to debut sukuk such as Kenya, Nigeria and Niger.

Malaysia remains the biggest issuer by far, with US\$23 billion issued by Q3 2016, capturing a 58% market share of total sukuk issued globally. Only Pakistan has increased its sukuk issuances during 2016 over 2015, while all other countries had a smaller volume of issuance when compared to 2015. It also returned to international sukuk market with an issuance in October 2016 for the first time since late 2014. This is one part of the government's effort to embark vast infrastructure spending to eradicate energy shortages in the country.

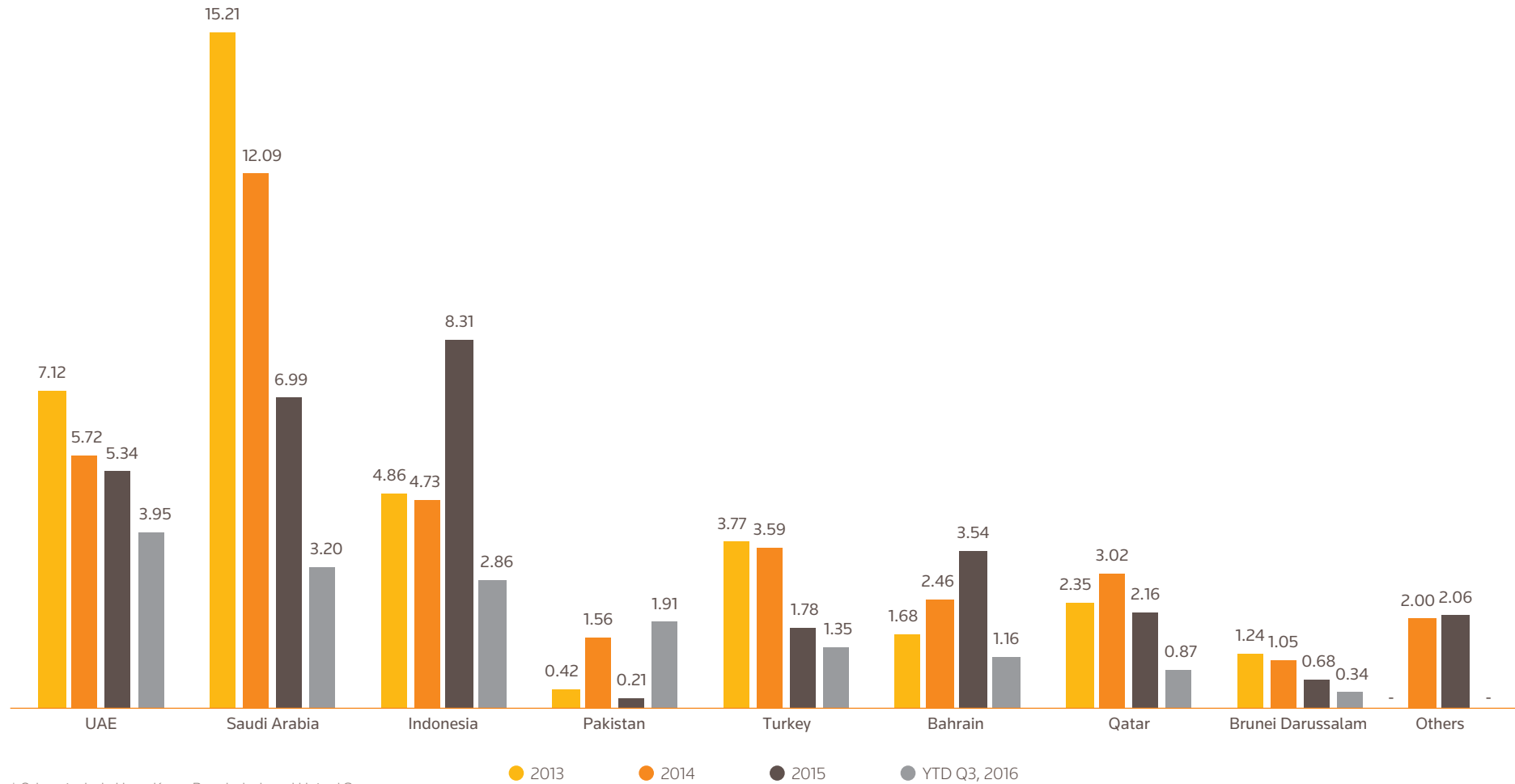
### MALAYSIA SUKUK ISSUANCE TREND BREAKDOWN

(US\$ BILLION, 2013-Q3, 2016)



Source: Thomson Reuters

GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY TOP COUNTRIES – EXCL. MALAYSIA (US\$ BILLION, 2013-Q3, 2016)



\* Others include Hong Kong, Bangladesh and United States  
 Source: Thomson Reuters

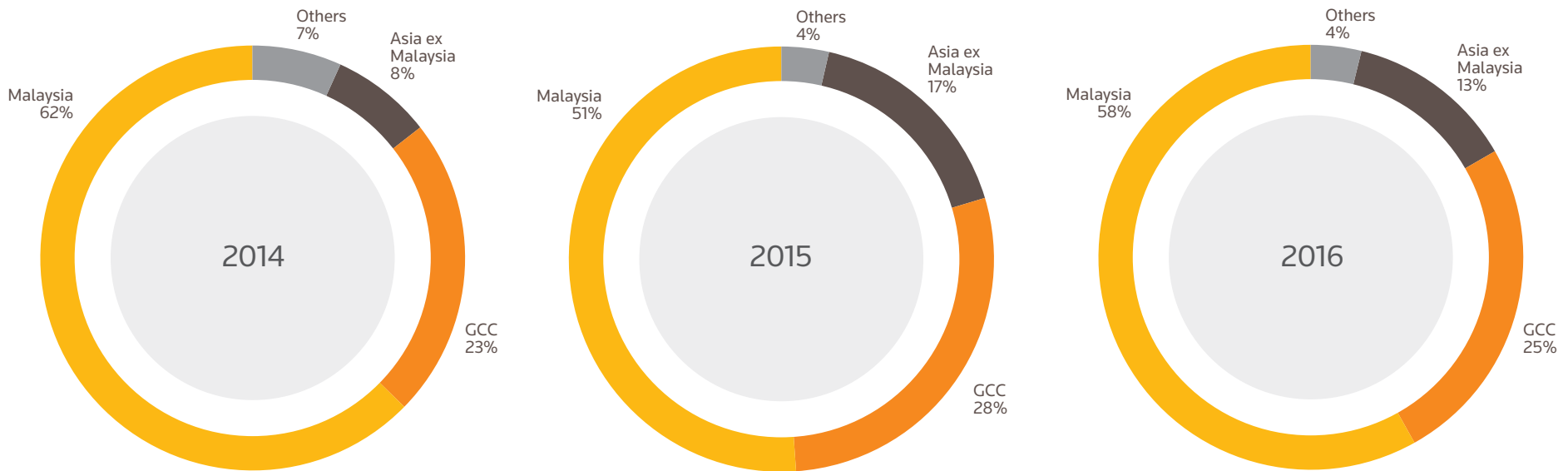
**A preference for bonds limits the GCC’s sukuk issuance**

Apart from Malaysia, the GCC remains the largest regional issuer with US\$10.04 billion issued by Q3 2016. With the drop in oil prices changing financial strategies since 2014, the GCC’s total sukuk issuances and its share of global sukuk issuances decreased in 2016, compared to 2015. The subdued sukuk issuances in 2016 are a reflection of GCC governments’ preferences for conventional bond issuances to tap liquidity from conventional international investors. These investors are looking to emerging markets for better returns as yields are zero or negative in other markets because of quantitative

easing. The UAE is the largest GCC sukuk issuer in 2016, overtaking Saudi Arabia. By sector, financial institutions are the biggest driver of the GCC’s sukuk issuances.

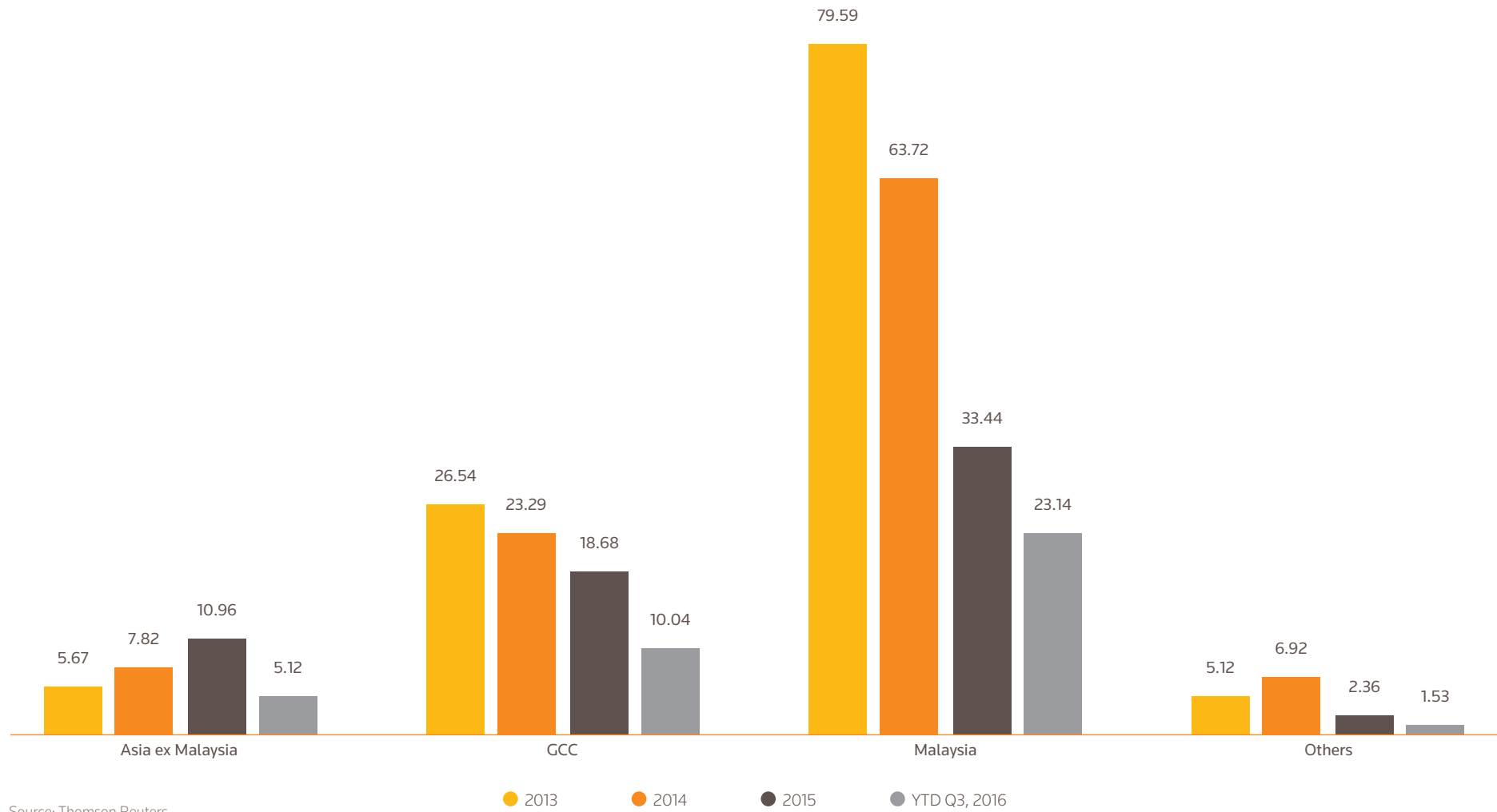
Other regions such as Asia (excluding Malaysia) had lower sukuk issuances in 2016 as well. Indonesia is trying to revive its sukuk market by raising its share from 13% of total debt issuances in 2015 to 50% over the next 10 years by increasing the value of issuances by 5% every year. The government plans to encourage the use of sukuk for funding infrastructure, agriculture and educational projects.

GLOBAL SUKUK ISSUANCE BY REGION



Source: Thomson Reuters

GLOBAL SUKUK BREAKDOWN BY REGION (US\$ BILLION, 2013-YTD Q3 2016)



**GCC continues to dominate sukuk market choice**

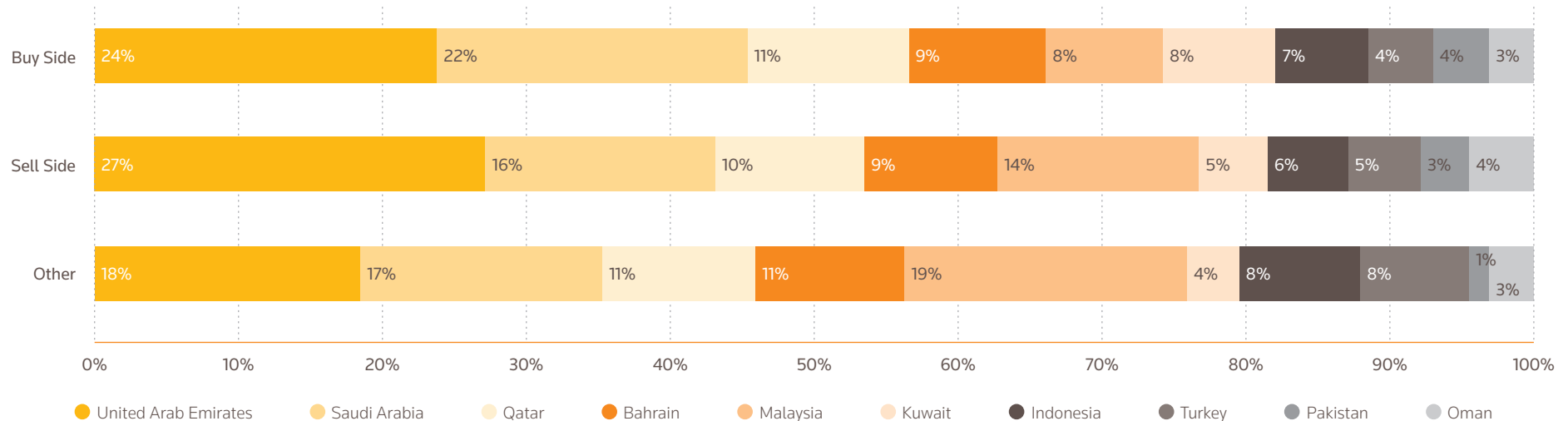
Our 2016 survey shows that investors and issuers still have a stronger preference for sukuk in the UAE and Saudi Arabia compared to other countries. This was followed by other GCC countries such as Qatar, Bahrain and Kuwait along with Malaysia for investors. For issuers, Malaysia is the third most preferred choice after the UAE and Saudi Arabia. Its active sukuk market is still supported by corporate issuances compared to declining government issuances since 2015.

After the drop in government sukuk, GCC sukuk markets are now mostly dependent on corporate issuances. Despite the drop in oil prices, which has caused fiscal difficulties in the GCC, government issuance expectations were barely met by H1 2016. Issuances from the governments of Sharjah and Oman and the frequent short-term issuances from the government of Bahrain for liquidity management purposes hardly

demonstrates a preference for sukuk issuances by GCC governments, as they made a conservative move to bonds. However, a sign of improvement appeared in August 2016, when Qatar Central Bank sold QAR 1.6 billion in sukuk. This issuance was met with QAR 2.4 billion bid exceeding the amount offered. It also sold QAR 2.625 billion in government sukuk the following month, which also suggests that liquidity is easing in the Qatari market, under pressure by low gas prices. Oman also sold US\$500 million in sukuk in July 2016 with a six-year tenor based on ijarah.

Although respondents showed a smaller preference for Pakistan and Turkey sukuk on both sides, Turkey raised US\$726 million in lira-denominated sukuk by the end of Q3 2016, as it sought to diversify its funding options and broaden its investor base. Meanwhile, Pakistan issued a USD-denominated sukuk during the same busy period.

**SURVEY FINDINGS – COUNTRY PREFERENCE**





**A continued appetite for international sukuk issuances from emerging Islamic finance markets**

Of the new and emerging Islamic finance markets, our survey findings show that the United States predominates among other markets in the opinion of investors, followed by Australia and Hong Kong. Meanwhile, issuers feel that Hong Kong is the best newer market for investment, followed by its neighbor China.

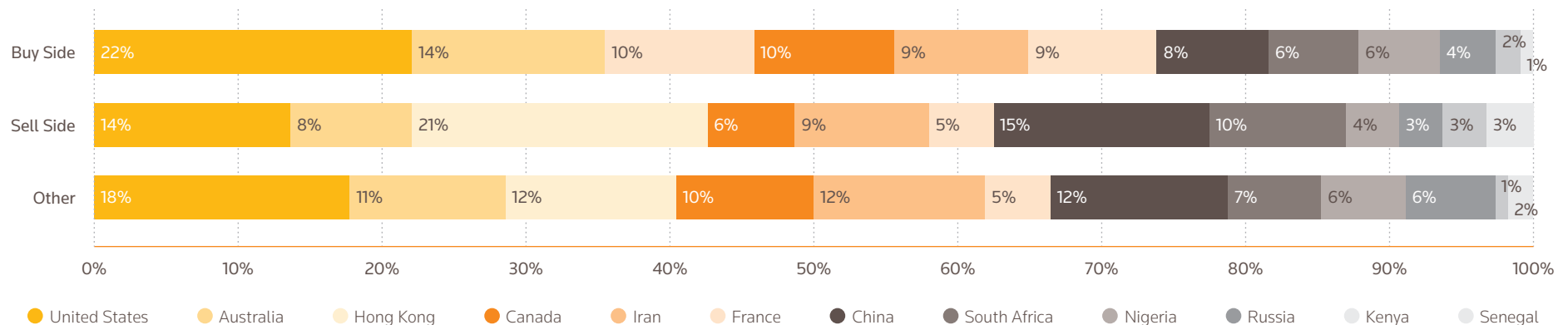
Given the success of the two previous international issuances by Hong Kong, it is not surprising that it is the most prominent among our sell-side respondents' preferences for new markets to invest in sukuk. The demand for top-rated Islamic dollar bonds is higher this year compared to previous years, as indicated by the international sukuk type preference by all market players. That is why there is an appetite for quality issuances by Hong Kong, the United States or Australia.

Hong Kong changed its tax rules in July 2013 to put the legal framework for corporate sukuk in line with conventional bonds, aiming to attract more international issuers and investors

to its market. The regulation could also pave the way for Chinese corporations to increase issuances, as 1.8% of China's population are Muslims. However, Hong Kong is still facing competition from Malaysia, with its active domestic sukuk market. The Chinese developer Country Garden chose Malaysia to issue its sukuk in December 2015, which was a blow to Hong Kong's ambition. Beyond better regulation, there remains a need for a comprehensive supportive ecosystem for Islamic finance, spreading consumer education and public awareness, to attract investors to Hong Kong. Institutional investors in Malaysia are already familiar with complex sukuk structures unlike other countries such as Hong Kong.

Iran, which faced UN sanctions until January 2016, has experienced a similar demand from both investors and issuers. The government is rolling out different initiatives including new debt tools to help its capital markets make a move from local corporate investors towards foreign investors in Iranian sukuk. However, the market is still constrained by its legal framework, which does not allow sukuk to be traded in foreign currencies such as USD. Its plan to expand government sukuk issuances should create pricing benchmarks to guide Iranian corporate issuers.

**SURVEY FINDINGS – OUT OF THE FOLLOWING EMERGING ISLAMIC FINANCE MARKETS, WHICH ARE THE 5 MOST ATTRACTIVE FOR SUKUK INVESTMENT?**



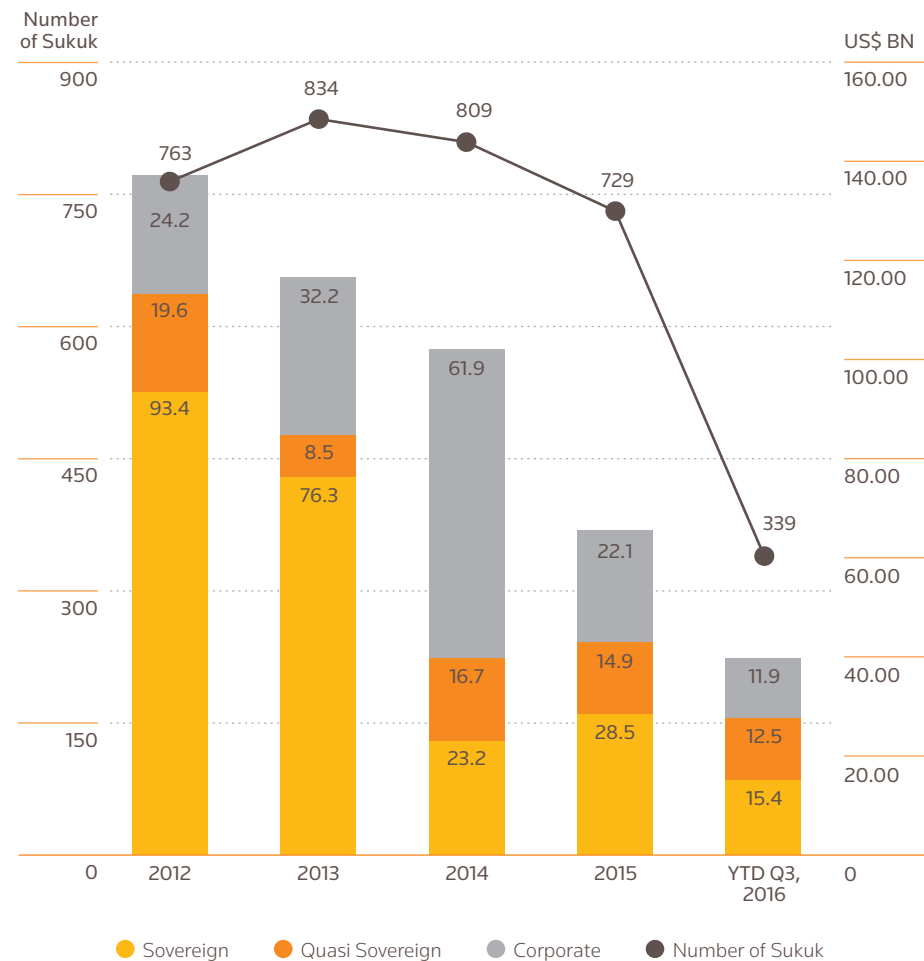
## Sector Preference

### An increased quasi-sovereign role in the sukuk market in 2016

The public, private and quasi-sovereign sectors all decreased in sukuk issuance volumes by Q3 2016. However, their contributions balance has shifted. Sovereign sukuk issuance share decreased by end of Q3 2016 to 39% from 43% in 2015 full year and corporate sukuk issuance share decreased as well to 30% from 34% in 2015. These were offset by the increased role of quasi-sovereign sukuk issuance by Q3 2016 as its share increased to 31% from 23% in 2015. These include Dana Infra and Prasarana Malaysia IMTN Program sukuk from Malaysia and Islamic Development Bank's MTN sukuk. While the usual sovereigns prefer to borrow bonds rather than sukuk due to demand from foreign investors, quasi-sovereigns are having an increasing role to ensure that the sukuk market remains active.

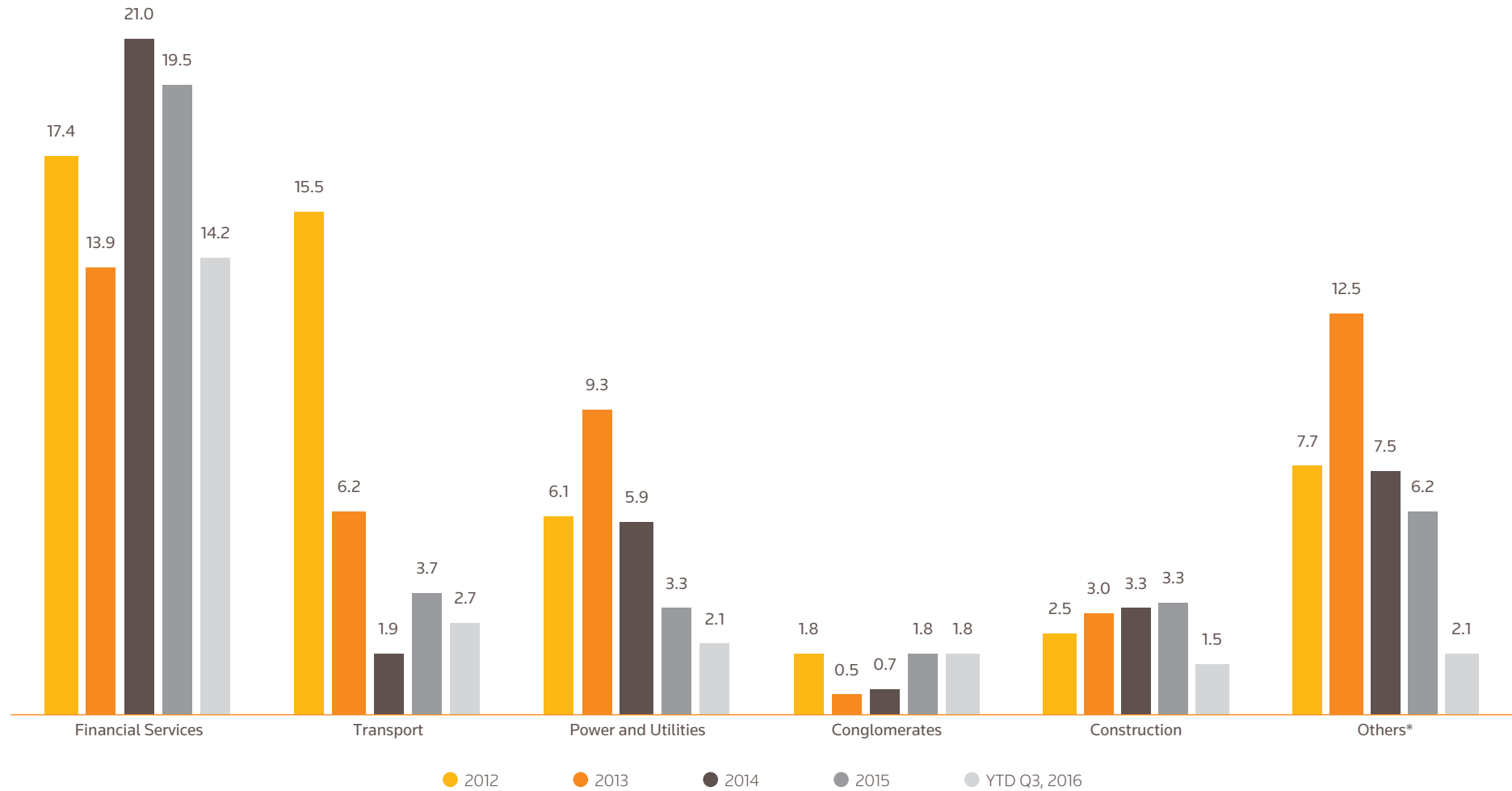
Financial institutions such as Islamic banks continue to drive corporate issuances, and their share of corporate sukuk issuances has increased to 58% in Q3 2016 from 51% in 2015. Its issued volume has decreased, however, in line with the global sukuk slowdown, to US\$14 billion in 2016 from US\$20 billion in 2015.

GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY ISSUER  
(2012 – YTD Q3, 2016)



Source: Thomson Reuters

GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY SECTOR (US\$ BILLION, 2012 – YTD Q3, 2016)



\* Others include Oil and Gas, Real Estate, Retail, Telecommunications, Services, Agriculture, Industrial Manufacturing, Health Care, Information Technology, Food and Beverages, Education, Consumer Goods and Mining and Metals  
 Source: Thomson Reuters

**Higher demand for sovereign and financial institution sukuk**

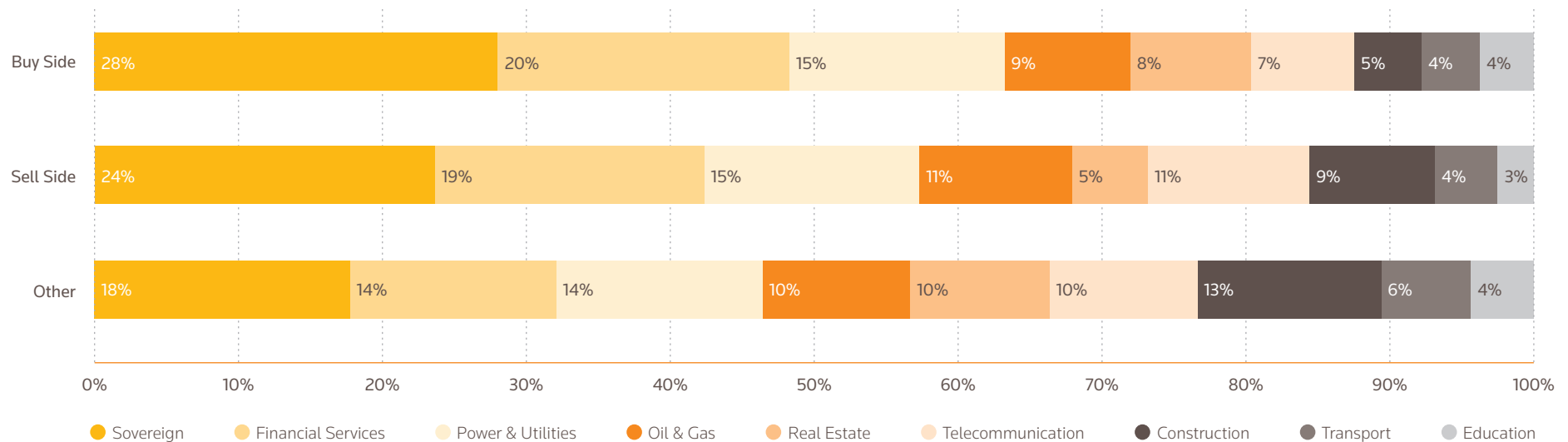
By sector, our survey respondents still prefer sovereign issuances, and financial services lead over other corporate sectors. 28% of the respondents prefer to invest in sovereign credit risk especially considering the current regional economic challenges. With the drop in government issuances, especially in the GCC, the demand for sovereign issuances is on the rise.

For financial sectors, Islamic banks are still hunting for funding sources to satisfy their tier 1 or 2 capital requirements to improve the systematic stability of the global finance industry mandated by Basel III. For GCC Islamic banks, this trend is expected to continue, with the issuance of the first Basel III-compliant sukuk by Abu Dhabi Islamic Bank. Sustained low oil prices could lead to a decline in public spending, which

would impact asset growth and quality in the financial sector in the region, although this would occur slowly, as GCC countries have large financial buffers from oil export surpluses. This is where prudential frameworks such as Basel III rules will need to be applied. The sukuk pipeline for financial institutions requiring capital boosting includes Kuwait Finance House, which could enhance tier 1 capital or supplementary tier 2 capital, and Kuwait’s Ahli United Bank, for tier 1 core capital. Outside the GCC, institutions in the capital-boosting sukuk pipeline includes Malaysia’s CIMB Bank for tier 2.

Sectors that are cyclically sensitive and have high credit risk because of the drop in oil prices, such as construction and real estate, are less desirable investment targets according to investors and issuers responding to the survey.

**SURVEY FINDINGS – SECTOR PREFERENCE**



## Currency Preference

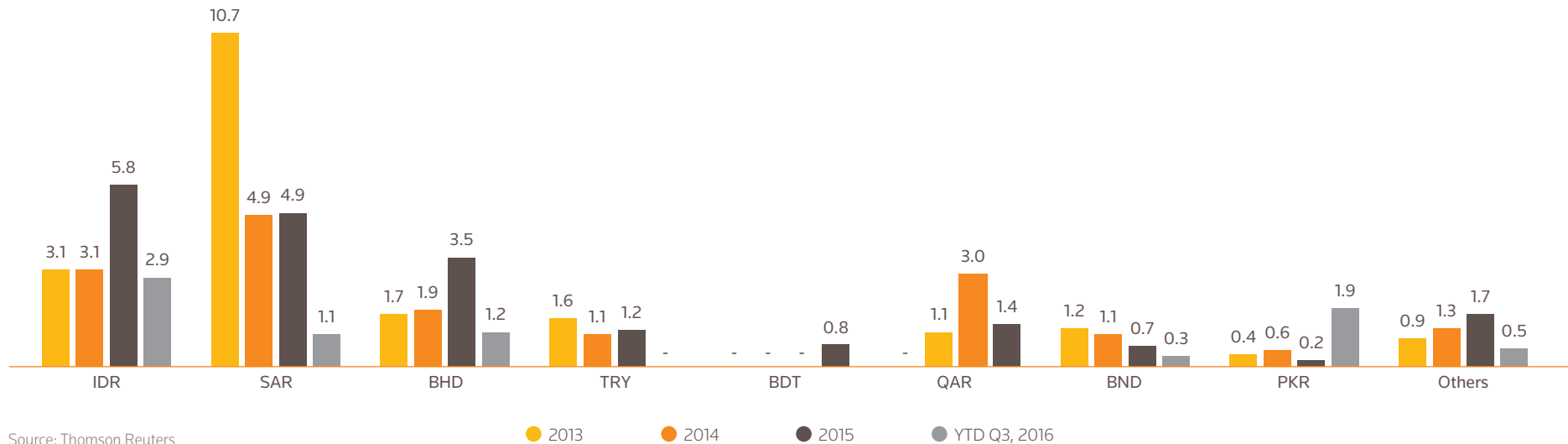
### Top preference for dollar sukuk issuances

After years of Malaysian ringgit sukuk as the most popular denomination for sukuk, US dollar is now the most issued currency, constituting 45% of total sukuk issuances globally. In line with figures from completed international issuances, US dollar is still the currency of choice of our survey respondents. Currencies that are pegged to US dollar also remain among the preferred currencies, as they have less currency risk. AED tops the pegged currencies, followed by SAR then BHD and QAR for both buy and sell side. The UAE is considered more resilient, as it remains among one of the stronger GCC markets due to its diversified economy with a strong credit rating of Aa. Other GCC countries such as Kuwait and Qatar also enjoy a credit rating of Aa.

GBP currency preference declined a little from 13% to 11% for the investors, but it declined significantly for the issuers from 33% to 4%. The British Pound crashed to a 31-year low of 1.3 USD/GBP in July 2016 following the UK's decision to leave the European Union (aka "Brexit") making it more volatile and less attractive to investors as this impacts their portfolio returns.

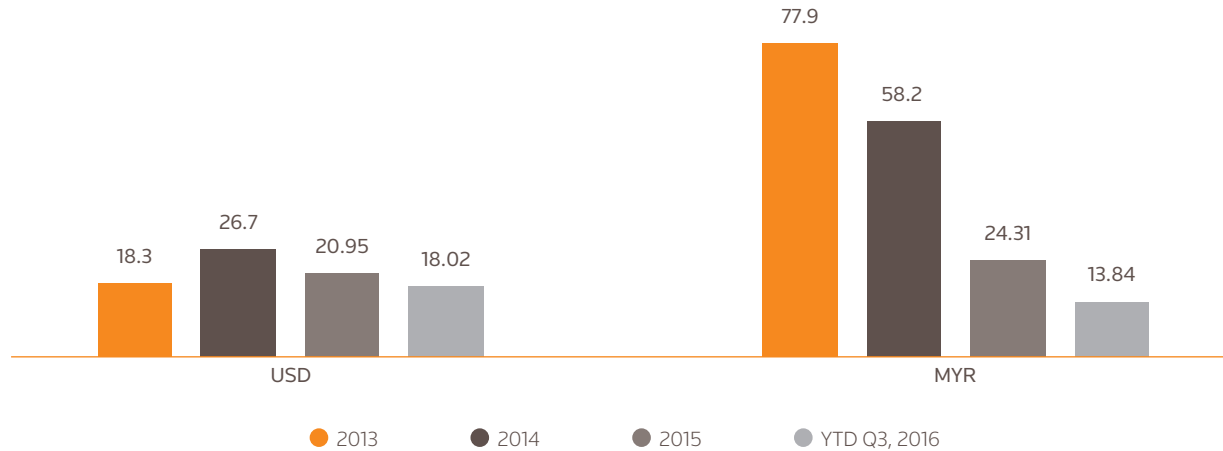
The value of Malaysian ringgit issuances, although lower compared to previous years, is the third most popular option for issuers. Malaysia remains the most active sukuk market and the ringgit has stabilized in 2016 after Malaysia has addressed its fiscal challenges. This is supported by the Islamic Development Bank's (IDB) plan to issue local currency sukuk in Malaysia after a three year hiatus from the ringgit market.

### GLOBAL SUKUK HISTORICAL TREND BY TOP CURRENCIES — EXC. MYR AND USD (2013 – YTD Q3 2016)



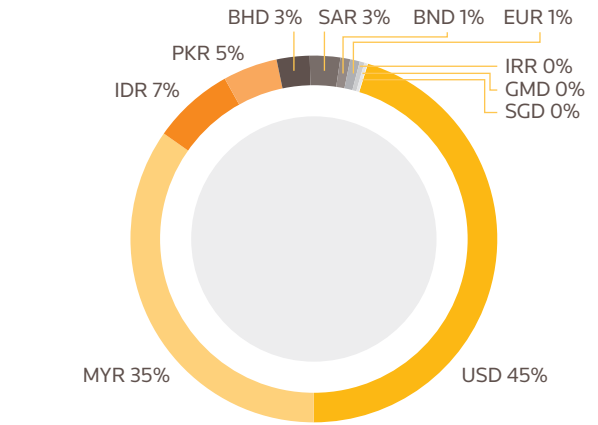


GLOBAL SUKUK HISTORICAL TREND: MYR AND USD (2013 – YTD Q3 2016)



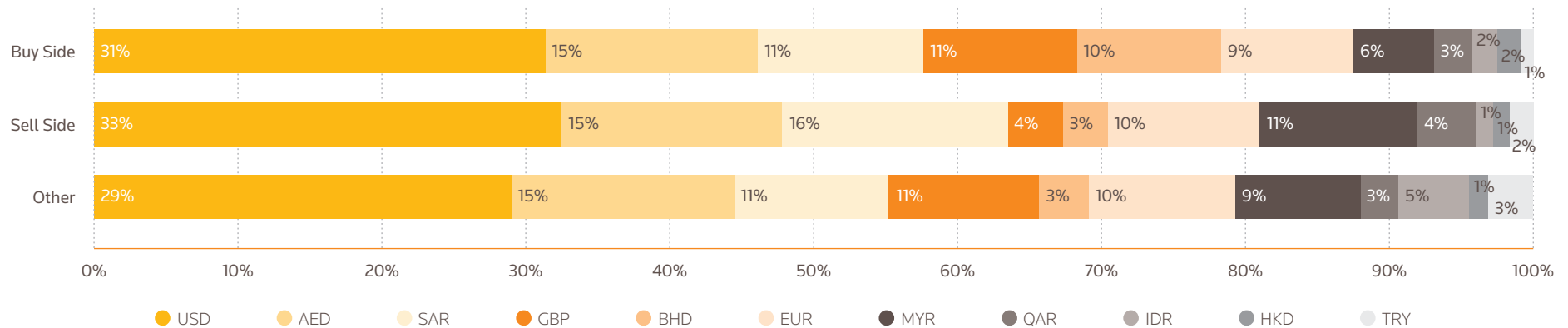
Source: Thomson Reuters

GLOBAL SUKUK ISSUED BY CURRENCIES (YTD Q3 2016)



Source: Thomson Reuters

SURVEY FINDINGS – CURRENCY PREFERENCE



## Rating Preference

### Relaxed demand for high ratings a result of sukuk issuance slowdown

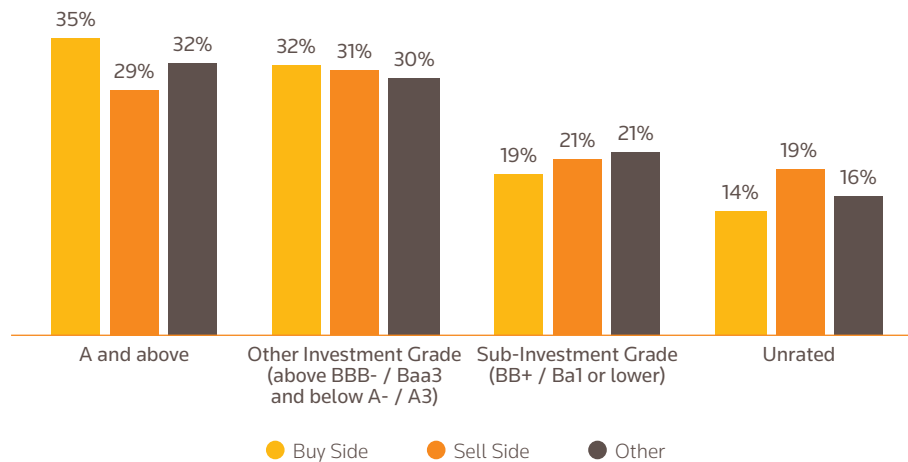
Our sukuk survey reveals that investors still prefer A and above rated sukuk over the lower-rated types. However, respondents preferring high-rated sukuk decreased vis-a-vis unrated sukuk, compared to the previous survey. Investors seem to be relaxing their demand for high-grade sukuk, given the lower supply in 2016.

The results indicate that the preference for unrated sukuk is higher among market players who have Shariah-compliance mandates (full or window) over non-Shariah-compliant parties. New parties, commonly conventional financial institutions that seek to enter the sukuk market are often disconcerted by their unfamiliarity with complex sukuk structures. Sukuk, unlike plain vanilla Eurobonds, need to comply with Shariah investment principles that prefer equity-like profit-sharing or asset-backed

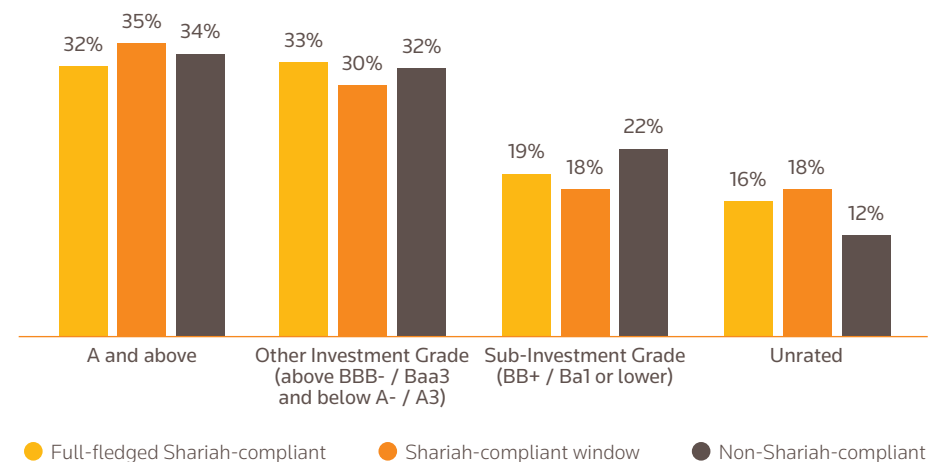
financing. Investors need to dig deep into the non-standardized legal documentation and structure of the sukuk, which takes time. This creates a challenge for the new investors' in-house credit analysis and for new issuers to build demand. Rating by credit agencies simplifies the process of portfolio selection for investors. By assigning a credit rating, the inflow of international funds from new or conventional investors (e.g. in Europe) towards sukuk could increase.

The higher demand from conventional investors for A and above ratings and other investment-grade sukuk also means that some issuers will need to turn to asset-backed sukuk, as these are more secure and more dependent on the asset value than the quality of the borrower. However, many issuers prefer asset-based sukuk in any case, as it is less costly because of the simpler legal documentation involved.

### SURVEY FINDINGS – RATING PREFERENCE BY MARKET POSITION



### RATING PREFERENCE BY SHARIAH MANDATE



## Structure Preference

### Wakalah continues to dominate in 2016

Since surpassing murabahah in 2014, wakalah structures had the highest value of new sukuk issuances in 2016. This is the case in particular because domestic Shariah rulings in GCC countries allow wakalah (but not murabahah) sukuk to be traded on the secondary market. Murabahah remains the most issued structure by value in Malaysia, which is one of the jurisdictions that permit their trading. However, the country has issued the majority of wakalah-based sukuk this year. In the first three quarters of 2016, 23 wakalah sukuk were issued, with a total value of US\$12.136 billion. Of these, 16 were issued in Malaysia.

Ijarah continues to be the most-issued sukuk structure by value in GCC countries, with Bahrain accounting for most of these. Until recently, ijarah had been the most popular structure for international issuances, but a sudden shift occurred to sukuk with underlying wakalah assets in 2015. The proportion of ijarah sukuk in the international market fell from 42% in 2014 to 14% in 2015, while wakalah accounted for 63% of issuances in 2015. The wakalah structure is also showing signs of taking over from murabahah as the most issued type of sukuk since 2015, given that the latter is required to be held to maturity in GCC markets.

Murabahah has maintained its dominance in domestic currency sukuk, with 80% of total issuances. Malaysia, in particular, accounts for 62% of all domestic issuances, where this structure is mainly used by domestic issuers to assist with liquidity management, meet statutory liquidity requirements under Basel III, and in some cases, maintaining monetary policy operations. The outlook for the wakalah structure is positive, with banks also issuing wakalah sukuk to comply with Basel III requirements.

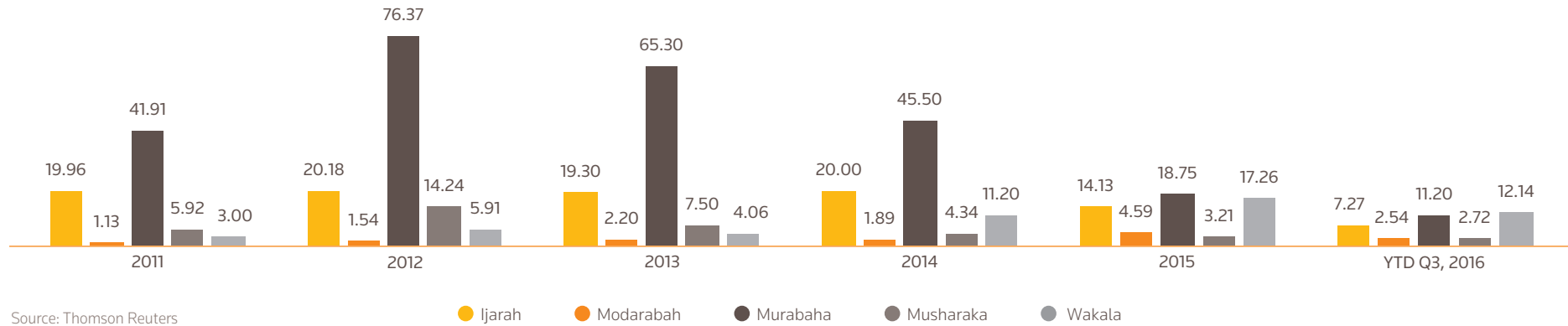
Among respondents, issuers' most preferred sukuk structures are ijarah and wakalah, which are preferred by GCC investors because of their tradability. Moreover, Malaysia has extended sales tax breaks for issuers of ijarah and wakalah sukuk until 2018. This incentive aims to ultimately attract overseas investors to the Malaysian market,

particularly away from the GCC markets, mainly to generate funding rather than to manage liquidity. By establishing an overseas investor base for sukuk that is familiar with investing in these particular structures, Malaysia will be able to attract more overseas issuers to its sukuk market in the future.

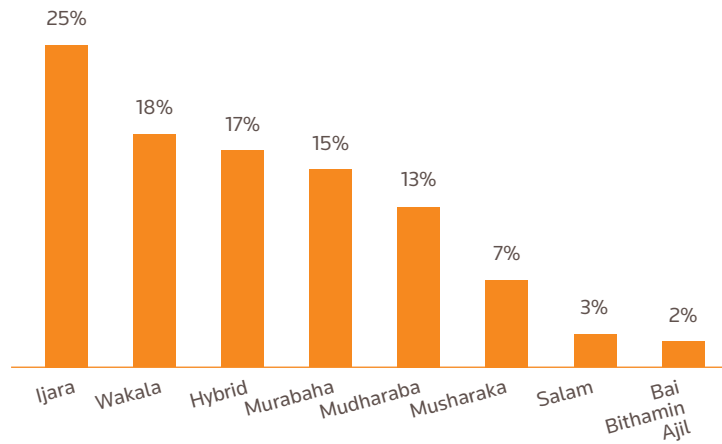
### GLOBAL SUKUK ISSUED IN 2016 BREAKDOWN BY STRUCTURE

Sukuk Structure	Amount Issued (\$ Million)	Number of Sukuk
Wakalah	\$12,136	23
Murabahah	\$11,201	116
Ijarah	\$7,269	26
Musharakah	\$2,725	21
Modarabah	\$2,537	66
Al-Wakalah Bel-Istithmar	\$1,945	3
Al Salaam	\$699	79
Mudarabah-Murabahah	\$533	1
Al-Istithmar	\$267	1
Ijarah-Musharakah	\$267	1
Bai Inah	\$242	2

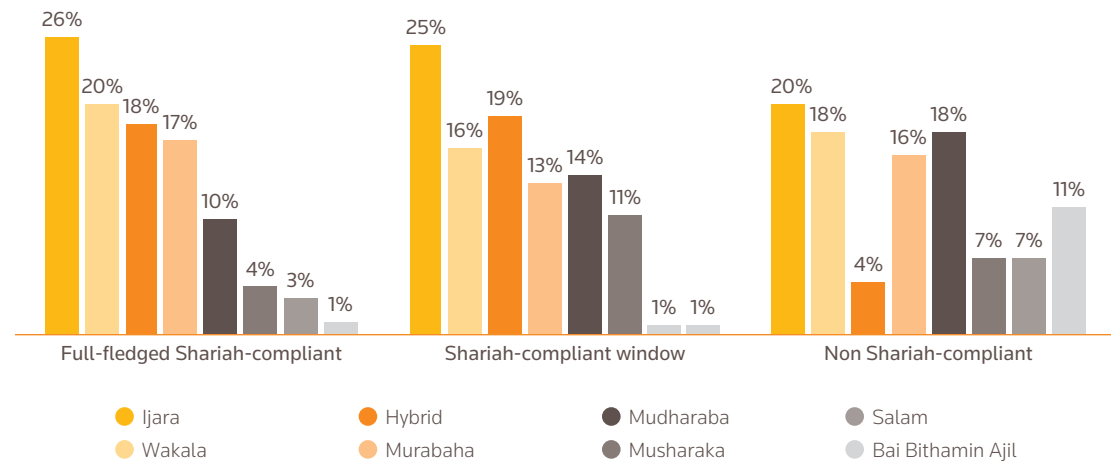
GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY TOP FIVE STRUCTURES (YTD Q3, 2016)



SURVEY FINDINGS — SELL SIDE SUKUK STRUCTURE PREFERENCE



SELL SIDE SUKUK STRUCTURE PREFERENCE BY SHARIAH MANDATE







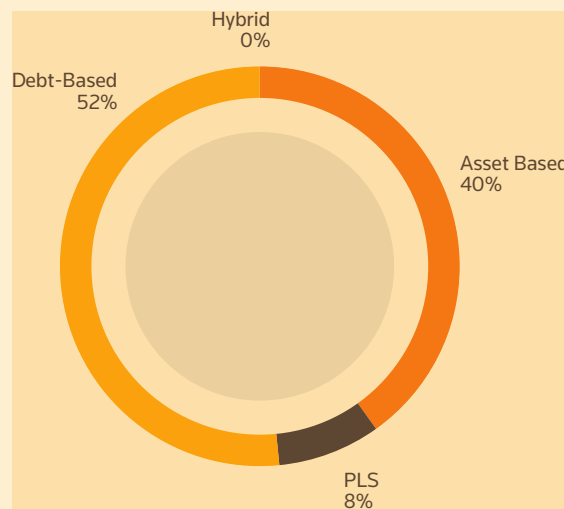
# EMERGING TRENDS IN SUKUK MARKETS

Sukuk markets have undergone tremendous upheaval during the past two years, driven by the drop in oil prices and signified by a typically large issuer (Bank Negara Malaysia) markedly reducing its issuance.<sup>1</sup> What has remained relatively consistent is the gradual shift of industry stakeholders away from debt-based structures. Stakeholders view such structures as compromising the authenticity of Islamic finance and, more importantly, bringing the same rigidity to Islamic finance that critics say makes debt instruments cause structural financial instability.

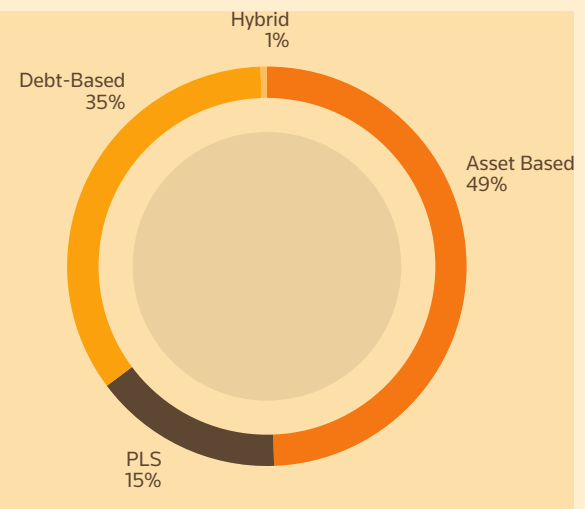
Primary markets for sukuk saw a sharp decline in the 12 months ending March 31, 2016 compared to a year earlier, falling 31%. Within this headline number, however, a summary overview of the sukuk market reveals an even larger 53% decline in issuance of debt-based structures like murabahah. These types

<sup>1</sup> For the entirety of this article, the time periods referred to as 2015 and 2016 will reflect data for the 12 months ending on March 31 of the respective year.

SUKUK STRUCTURES AS OF MAR 2015



SUKUK STRUCTURES AS OF MAR 2016



Source: Thomson Reuters

Note: Data for 2015 and 2016 are shown for the 12 months ending on March 31. Asset-based includes ijarah and wakala sukuk. PLS includes mudarabah and musharakah. Debt-based includes murabaha, salam, BBA and bay al-inah.

of sukuk have attracted criticism in the past, such as the \$500 million murabaha sukuk issued by Goldman Sachs in 2014. By contrast, there has been a corresponding rise in profit-and-loss sharing sukuk, which are widely viewed as best embodying the principles on which Islamic finance is built. Issuance of straight musharakah and mudarabah sukuk rose by \$2 billion (32%).

### The Malaysian Effect

This stark shift in structures used in new sukuk issuance should not be viewed in isolation from the wider factors affecting new issuance, particularly the reduction in issuance from the world's largest sukuk issuer, Malaysia, as foreign banks have extensively used Malaysian sukuk for their liquidity needs.

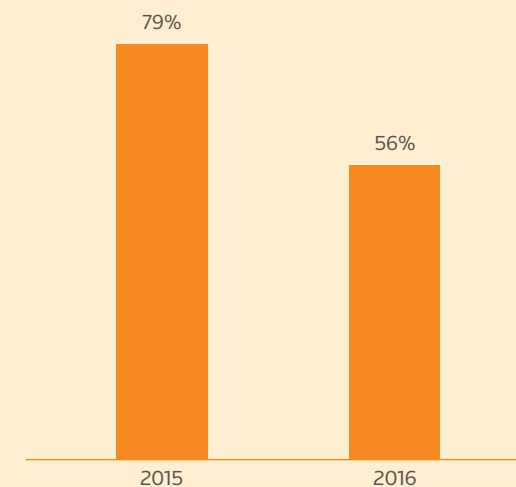
Unlike most other countries regulating Islamic finance, Malaysia permits trading in debt-based sukuk. This is reflected in the breakdown of Malaysia's sukuk market, where nearly four-fifths of the sukuk issued in 2015 was debt-based. This ratio has fallen just over 50% in 2016 as Bank Negara's issuance has dropped.

The Malaysian approach has facilitated a much deeper capital market, particularly when viewed in secondary market liquidity. Moreover, because of the big contribution of Bank Negara to the overall issuance volumes, the market has been much more domestically focused. Nearly 90% of Malaysian sukuk in 2015 was ringgit denominated, while nearly two-thirds of the non-ringgit sukuk issued during 2015 was denominated in hard currencies (mostly USD).

Most of the issuance outside of Malaysia conforms to the structure preferences of the Gulf Cooperation Council (GCC) investors, who shun trading in sukuk that represent financial receivables (rather than income streams connected to underlying activities or assets). This preference has led investment bankers to rely on two structures (ijarah and wakalah) that best meet these expectations. It has not led to much innovation on the profit-and-loss sharing front.

Before presenting and analyzing the sukuk market outside of Malaysia, it key to note that the rise in profit-and-loss sharing sukuk globally has entirely

### DEBT-BASED SUKUK SHARE IN MALAYSIA



Source: Thomson Reuters

Note: Data for 2015 and 2016 are shown for the 12 months ending on March 31.



IT IS LIKELY THAT  
THE GREATEST DEGREE  
OF INNOVATION...  
WILL COME FROM ISSUERS  
IN THE NON-FINANCIAL  
CORPORATE SECTOR  
LOOKING TO SUKUK  
MARKETS TO FUND THEIR  
BUSINESS LIQUIDITY NEEDS.

occurred in Malaysia's market. Even though issuance dropped from \$60.2 billion in 2015 to \$38.2 billion, the volume of musharakah and mudarabah sukuk rose from \$3.6 billion to \$6.4 billion. This rise could reflect the influence of greater market depth and a centralized Shariah board to provide the context within which new innovative structures can develop.

### Global Trends Outside of Malaysia

The Malaysian market aside (i.e. disregarding Bank Negara's issuance decisions on the aggregate breakdown of structures used in the sukuk market), there has been a much smaller shift in structures used between 2015 and 2016. By and large, most sukuk are still issued using asset-based structures. Profit-and-loss sharing structures are not negligible in the overall issuance, however, and they represent a larger share of the market than in Malaysia.

In recent years, there has been a change in issuer preferences relating to asset-based structures. The ijarah structure has become less common in sukuk, while the wakalah structure has become more

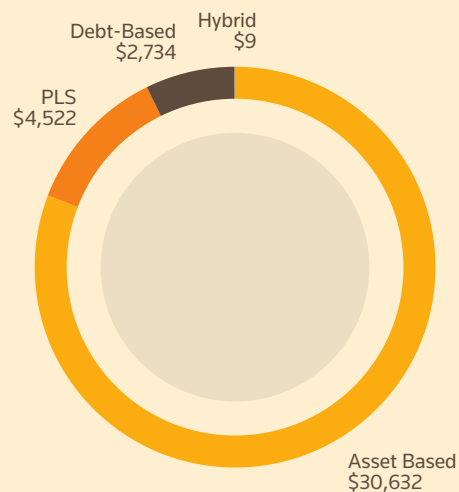
common. One reason may be that it allows issuers, particularly those who prefer holding few tangible assets, to use a smaller level of these assets, including financing assets such as ijarah which are asset-based themselves. This allows them to create a larger sukuk by adding murabaha contracts into the mix, provided that they remain under 50% of the total size at issuance. Although it is included as an asset-based structure in the charts above, it functions in many cases as a hybrid structure.

For example, a potential issuer with a building valued at \$100 million would be limited to issuing an ijarah sukuk with this building to raise \$100 million because the building would be sold (and later bought back) at the initial value, creating the transaction. With a wakalah structure, the issuer could increase the size of the transaction by combining the \$100 million from the ijarah building with \$100 million in murabaha financing to raise \$200 million.

Given the structuring cost differential between a conventional bond and a sukuk (and assuming the

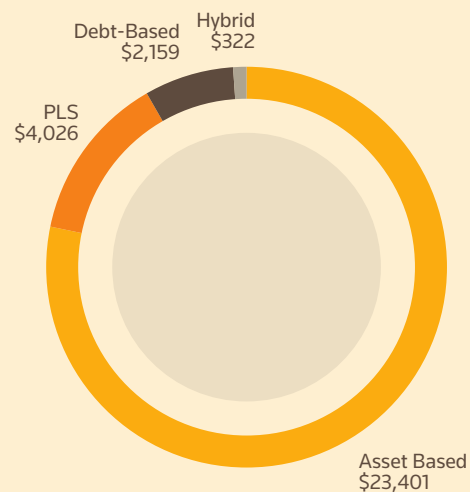


### SUKUK STRUCTURES AS OF MAR 2015 EX. MALAYSIA



Source: Thomson Reuters

### SUKUK STRUCTURES AS OF MAR 2016 EX. MALAYSIA



cost of structuring is similar), the economy of scale of large issues makes it possible for more issuers to tap the sukuk market using a wakalah structure rather than an ijarah. This may explain some of the shift towards this structure currently observed. However, considering the lack of many repeat issuers in the market, there is also a possibility that the increase in the use of a wakalah structure is due to an increase in the share of sukuk issued by financial institutions, which tend to hold fewer physical assets.

In future years, changes in the composition of sukuk structures will need to allow for the widest share of sectors—both those with significant tangible assets and those lighter in tangible assets — to access sukuk markets. For the time being, as in conventional fixed income markets, most of the issuers are sovereigns and financial institutions. However, it is likely that the greatest degree of innovation in terms of structures will come from issuers in the non-financial corporate sector looking to sukuk markets to fund their business liquidity needs.



**HUSSAIN AL QEMZI** is a seasoned banker renowned for his wise leadership and proven expertise in adopting, steering and managing strategic projects, business development and innovation initiatives. Mr Al Qemzi has an impressive and broad experience of over 29 years in the banking and financial services sector. He has worked with leading financial institutions in the UAE, and leads the Noor Investment Group and its flagship entity Noor Bank as its CEO.

Under his leadership, Noor Bank has received several prestigious industry awards, which most recently include: Best Islamic Bank in the UAE, Global Finance Magazine, World's Best Islamic Financial Institution Awards 2016; Best Islamic Real Estate Provider, Global Finance Magazine, World's Best Islamic Financial Institution Awards 2016 and Best Islamic Bank in the UAE, EMEA Finance Middle East Banking Awards 2015. Under his guidance, the Bank's credit rating was also affirmed by Fitch to 'A-' with a stable outlook for 2015/16.

As a result of his achievements, Al Qemzi was named as 'CEO of the Year' at the EMEA Finance Middle East Banking Awards 2015, as well as 'Islamic Banking CEO of the Year' at the prestigious CEO Middle East Awards 2015.

# OPPORTUNITIES IN THE CHANGING SUKUK MARKET

**Hussain Al Qemzi**, Group Chief Executive Officer of Noor Investment Group LLC and Chief Executive Officer of Noor Bank PJSC

The global economy has witnessed a rapid growth in Islamic finance with issuers interchangeably using conventional and Islamic capital market instruments. Numerous typically conventional issuers, including sovereigns such as United Kingdom, South Africa, Luxembourg, and Hong Kong, have ventured into issuing Islamic paper, which points to the growing demand for Islamic instruments.

The current year started amid uncertainty and volatility because of fluctuating oil prices. While this had multitude repercussions for the global economy, the macroeconomic position of oil-exporting Middle Eastern countries was impacted heavily in particular. As reported by the IMF, the Gulf States lost virtually US\$360 billion in revenues from oil sales, leading to fiscal deficits in several nations. This resulted in reduced fiscal spending such as state subsidies, the privatization of public entities, and the issuance of new debt to support budgetary requirements. Most of the GCC

sovereigns turned to the capital markets to meet these funding requirements, including both conventional and Islamic debt-raising with public and private issuances.

### Sukuk trends

The first quarter of 2016 remained largely dormant, witnessing a dearth of new capital market issuances. The fixed income markets came to terms with the reduced oil price by the second quarter, with a wide array of issuers lining up to tap available liquidity. This was apparent after one of the largest bond issuances by the State of Qatar, amounting to US\$9 billion, followed by an issue by the Government of Abu Dhabi amounting to US\$5 billion, its first in seven years.

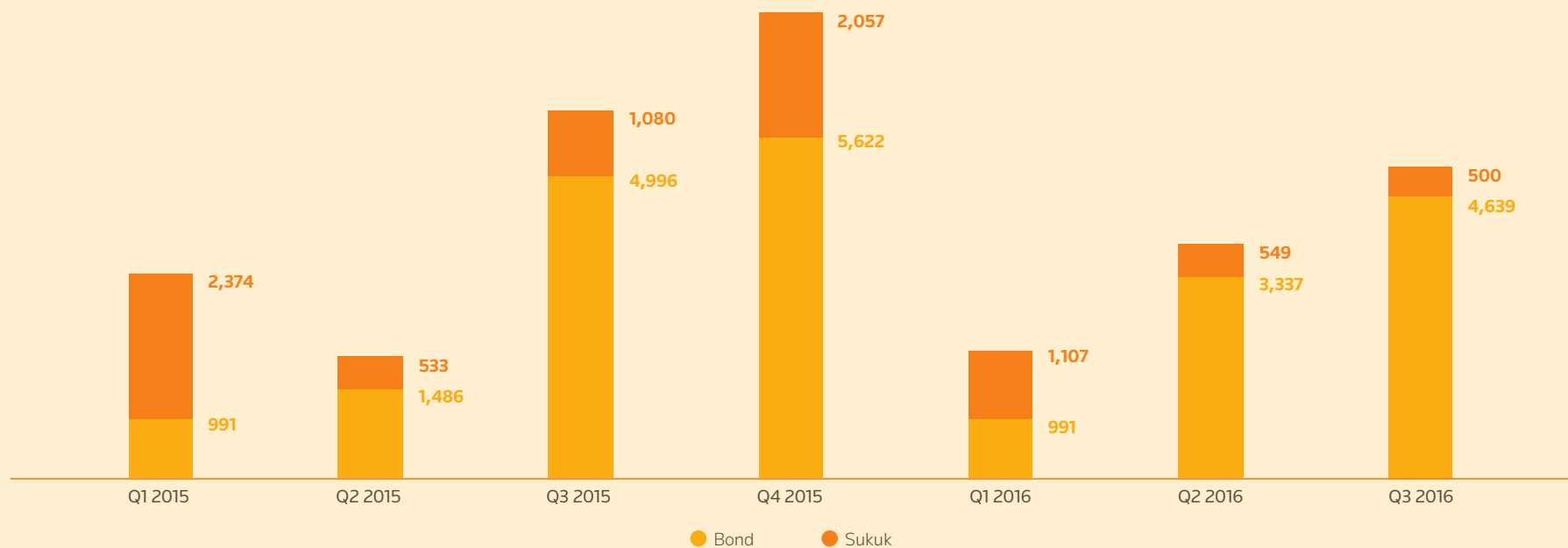
It is not typical for regional sovereign issuers to tap the market with such appetite and frequency as we have seen recently. While we expect a decent pipeline for Sukuk issuances during the remaining part of the year, we expect conventional bonds to be much more numerous, mainly on account of expected sovereign regional issuances. For example, the Kingdom of





WHILE WE EXPECT A DECENT PIPELINE FOR SUKUK ISSUANCES DURING THE REMAINING PART OF THE YEAR, WE EXPECT CONVENTIONAL BONDS TO BE MUCH MORE NUMEROUS, MAINLY ON ACCOUNT OF EXPECTED SOVEREIGN REGIONAL ISSUANCES.

GCC SOVEREIGN DEBT ISSUANCES IN 2015 AND 2016 (US\$ MILLION)



Source: Thomson Reuters



Saudi Arabia is expected to issue a US\$10 billion bond to capitalise on the strong global appetite for sovereign paper.

The perception of a drop in sukuk issuances is mainly a result of the large value of conventional issuances. This is more a case of the large size of conventional issuances undertaken by the sovereign issuers from the region being compared to the lower actual volume of sukuk issuances. As the year has progressed, we have witnessed a large number of Islamic issuances undertaken by regional financial institutions and corporations.

### Long-term advantages

Regional issuers with both Islamic and conventional issuances have largely witnessed their sukuk curves trading below the conventional counterparts, implying the pricing benefits that issuers can undertake with Islamic paper. Additionally they can take advantage of a larger pool of liquidity readily available from Islamic investors. In the long run, the value of sukuk issuances is expected to rise considerably, with a recent Thomson Reuters report predicting the value of Sukuk issuances rising to US\$250 billion by 2020.

Unlike conventional bonds, sukuk offerings allow issuers to tap into both the growing Islamic investor

community, as well as the Western institutional investor community. The sukuk market is becoming increasingly attractive to European and US investors as they seek to diversify portfolios and achieve higher returns via emerging market investments.

For the traditional investor, Islamic funds are safe, as they do not engage in excessive speculation; their trading turnover is generally low, which makes Sukuk less volatile than conventional bonds.

### Caution in the short-term

Global sukuk issuance has declined since 2015, and this is expected to continue a similar trajectory during this year but at a slower pace. The sukuk market experienced a correction in 2015 when the Malaysian Central Bank decided to stop issuing short-term products and to switch to other instruments for liquidity management for Islamic financial institutions. The volume of issuances in the first half of 2016 is on the lower end of the spectrum, particularly compared with conventional issuances, although the volume has witnessed an increase in the second half.

According to S&P Global Ratings, the sukuk market could also benefit further from the European Central Bank's (ECB) quantitative easing. Yields have been low or even negative for prolonged periods across

Europe. As the ECB has opened wider liquidity taps to fight the deflationary pressures, some investors are actively looking at emerging market instruments for better yields, and S&P believes that this will benefit the Sukuk market.

Recent global macroeconomic variables, including the stability of the Fed rate, have led to a flush of liquidity from the emerging market funds. With yields depressed in the emerging markets, we have witnessed many regional issuers such as Emaar and DP World undertaking issuances. We anticipate an increase in demand for emerging market issuances, which shall invariably benefit the Sukuk market, given most of the Sukuk issuances are in emerging markets. We also anticipate further sovereign sukuk issuances in the GCC mainly due to the low oil prices resulting in widening budget deficits for various GCC countries.

Despite this brief period of tranquility, the future remains bright for Sukuk issuances in the long-term. After all, it is widely anticipated that the Sukuk market and the Islamic finance space will grow at a rapid pace over the years to come.



## CHAPTER 3

# Sukuk Supply and Demand Equilibrium



## Global Sukuk Supply

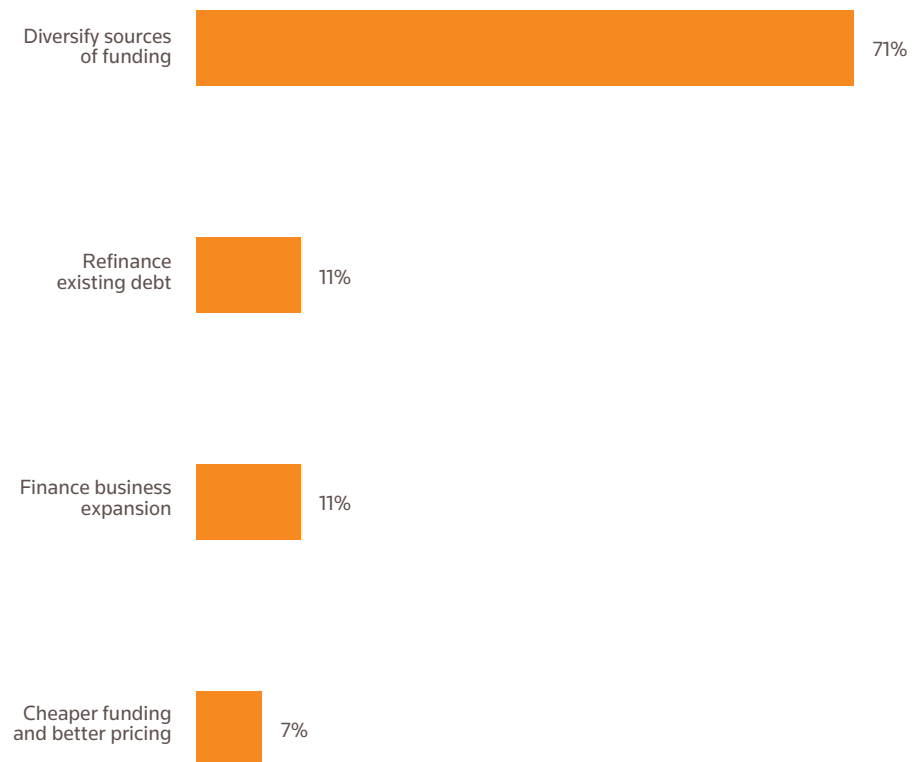
### Reasons to issue sukuk

#### 2016 survey reveals that diversification is key reason to issue sukuk

In our survey, 71% of debt issuers chose establishing a diversity of funding sources over other reasons to prefer using sukuk instruments. In last year's survey results, the share for this choice was only 45%, while a stated preference for cheaper funding and better pricing has dropped dramatically from 30% for last year's survey to 7% only in this year's survey. When compared to bonds, sukuk generally have additional costs attached, namely Shariah documentation fees and advisory costs, although this is expected to gradually decrease as issuers become regular sellers. The demand for better liquidity in the secondary market also means that investors are demanding higher yields in these markets.

Moreover, countries that have relied on commodity exports and are therefore experiencing higher budget deficits have been forced to issue international sukuk as local currency borrowing costs are growing as a result of lower banking liquidity. The average yield increases in step with the further need of funding by these sovereigns.

#### SURVEY FINDINGS – WHAT IS THE PRIMARY REASON TO ISSUE SUKUK?



## Refinancing options

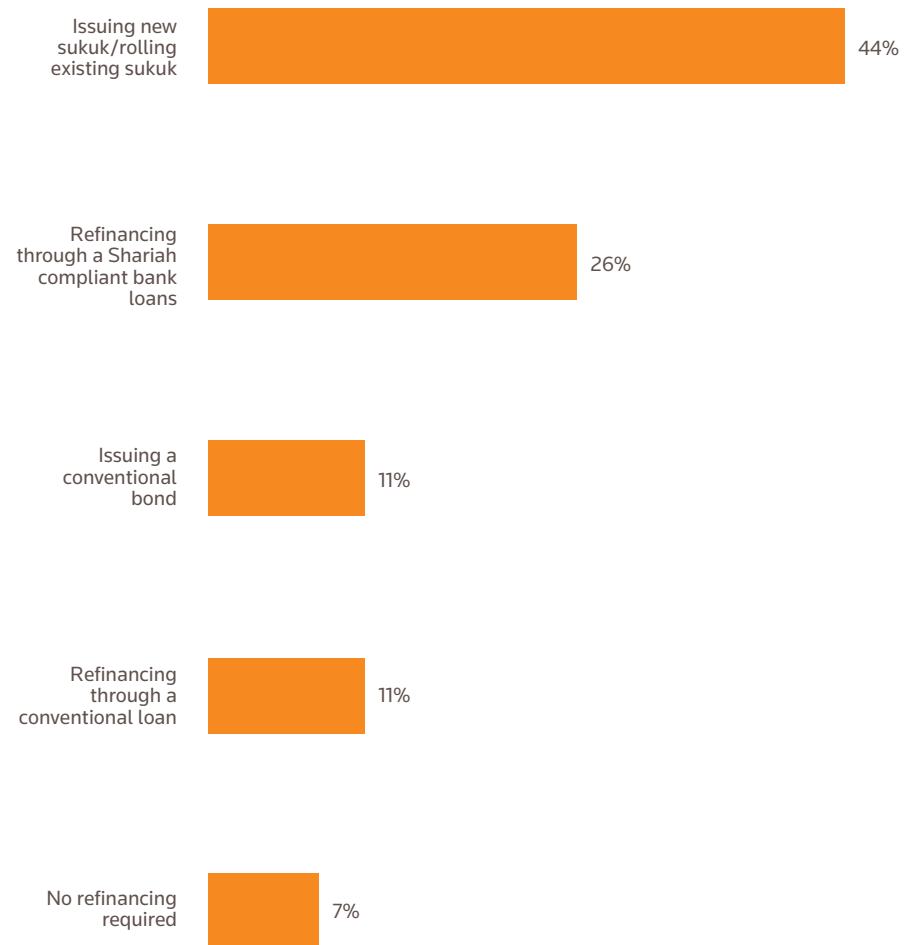
### Sukuk remain top preference for financing despite a continued decline in issuances

The survey shows that 44% of issuers find that the most appealing option to refinance their debt is to issue sukuk, while 26% prefer refinancing through Shariah-compliant loans. Although this may not reflect the current state of the market, it is an indication that there is still a strong interest from the sell side in refinancing their debt through sukuk, with the greatest interest coming from full-fledged Islamic institutions. This is also supported by recent sovereign issuances from countries such as Pakistan, Oman and Bangladesh, with the purpose of finding infrastructure programs and financing their budget deficits.

The least preferred refinancing options were conventional bonds and bank loans, at 11% each. However, this does not reflect the direction in debt capital markets, as GCC sovereigns in particular have recently preferred to issue conventional bonds to sukuk for funding their budget deficits and development programs.

Our survey breakdown shows that full-fledged Islamic institutions have a preference for sukuk over Shariah-compliant loans as a refinancing option. This could potentially create new opportunities for investors in the sukuk market, especially with the recent drop in supply and liquidity. Shariah-compliant bank windows, on the other hand, seem to prefer refinancing through Shariah-compliant loans to sukuk.

### SURVEY FINDINGS – AS AN ISSUER, WHAT IS THE MOST APPEALING DEBT REFINANCING OPTION FOR 2016 AND 2017?





## How to make sukuk more appealing

### **An active secondary market is necessary to make sukuk more appealing**

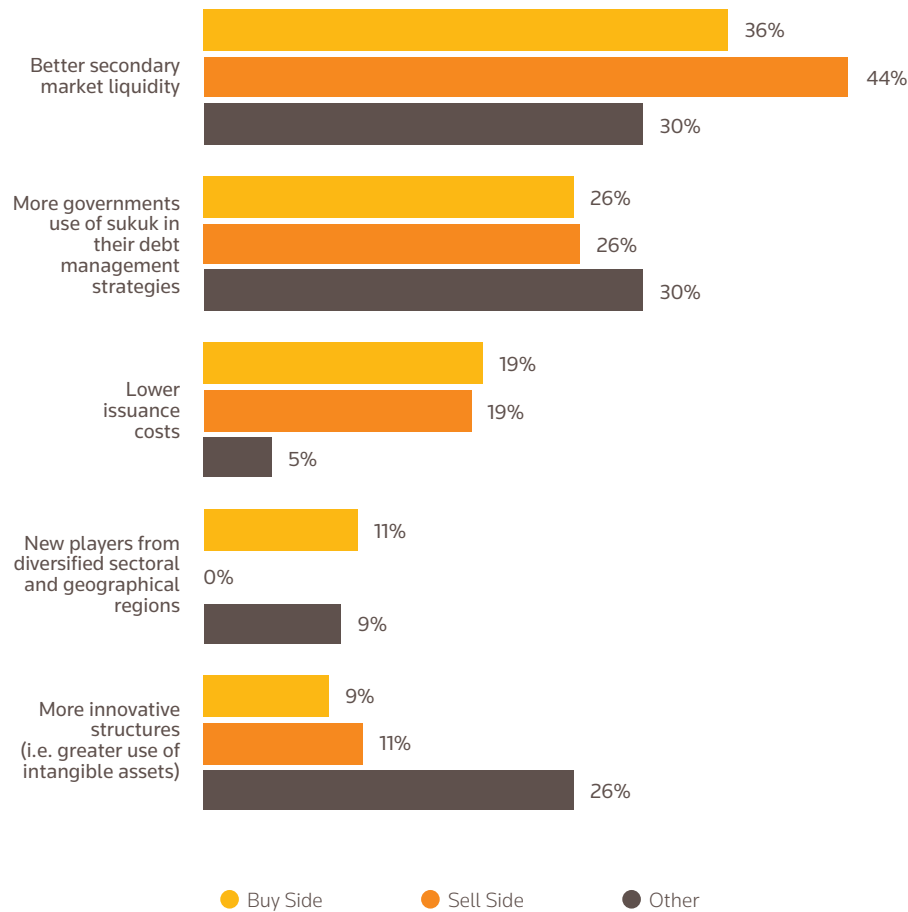
Most of our survey respondents, including Shariah-compliant and non-Shariah compliant market players, chose better secondary market liquidity as the most important improvement to make the sukuk market more appealing. The secondary market for sukuk has shrunk since 2015 because of BNM's short-term sukuk issuance policy, the overall drop in issuances and lack of new players entering the market.

The second-place recommendation was for more governments to use sukuk for their debt management. This may be achieved at a slow pace, as traditional markets that are affected by the drop in oil prices such as GCC nations are opting for conventional bonds more than sukuk as it is quicker to issue and has lower issuance costs. The third most popular choice was to make sukuk more appealing for market players by reducing its cost. This could be achieved through the standardization of sukuk issuances. Another cost in some countries is a requirement for credit ratings, which is hampering borrowers with weak credit profiles who turn instead to bank financing. This is a reason Malaysia is planning to remove mandatory credit ratings for corporate sukuk in 2017. 2016 has witnessed a few sovereign sukuk issuances such as Qatar, Oman and Emirates of Sharjah. However, the volume is lower compared to 2015.

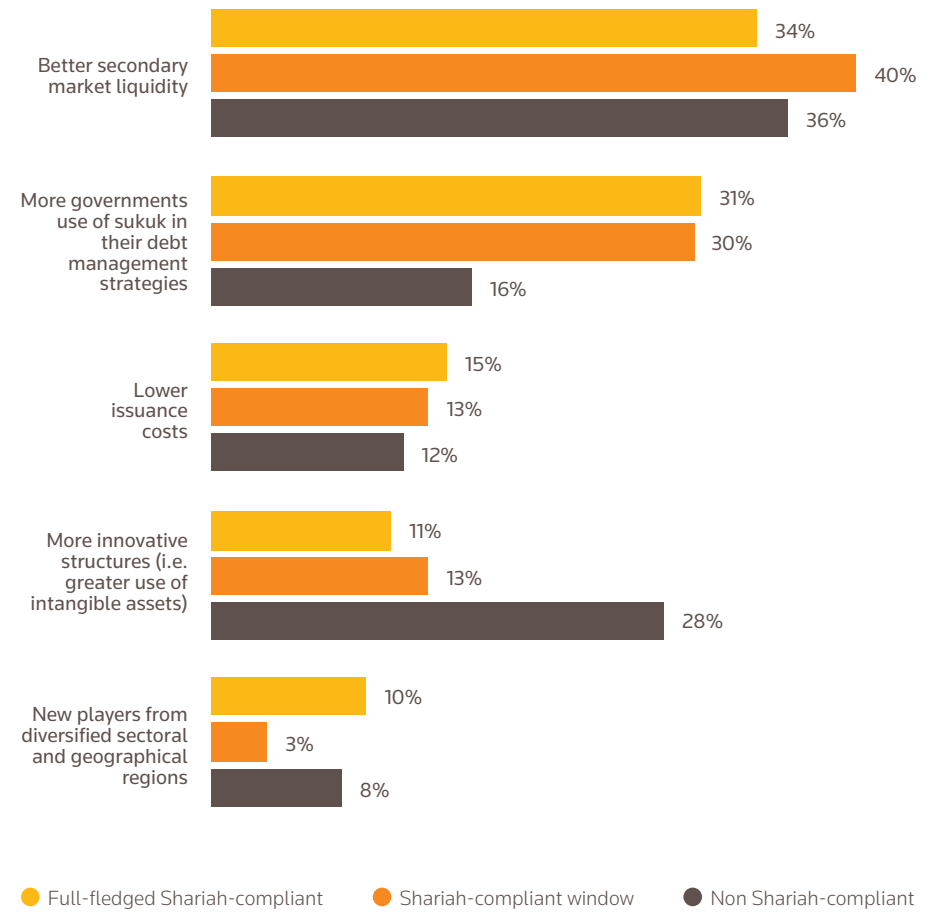
Secondary market sukuk volumes could improve as non-traditional markets from Africa, a home to a quarter of the world's Muslim population, are entering the sukuk market. Nigeria, Niger and Kenya are planning sukuk issues to finance infrastructure, while Togo, Ivory Coast and Senegal have already issued sukuk in Q3 2016. This was a key factor in the opinion of 11% of investors and 9% of market players other than issuers and investors.

Survey respondents considered JP Morgan's decision to add sukuk to its emerging market indices starting October 31, 2016 another important factor that will increase the appeal of sukuk for non-traditional investors. This will increase the secondary market's liquidity, as it will help sukuk shift away from its traditional buy-and-hold investor base. However, this is expected to come at a cost, as they will require minimum criteria such as a credit rating and regulatory filing requirements. This will be a benefit to sovereigns and corporations with high credit ratings and international sukuk. USD sukuk from Malaysia, Indonesia and Turkey will be included in JP Morgan's flagship EMBI Global Diversified index.

SURVEY FINDINGS – IN YOUR OPINION, WHAT IS REQUIRED TO MAKE SUKUK MORE APPEALING FOR MAINSTREAM ISSUERS/INVESTORS?



BY SHARIAH MANDATE – IN YOUR OPINION, WHAT IS REQUIRED TO MAKE SUKUK MORE APPEALING FOR MAINSTREAM ISSUERS/INVESTORS?





# ADDITIONAL TIER ONE SUKUK SHOW WAY TOWARDS THE FIRST COCO SUKUK ISSUANCE



The market for contingent convertible (CoCo) bonds has grown since they were first introduced after the Global Financial Crisis in anticipation of Basel III rule changes that raise minimum capital requirements and limit the use of 'old' Tier 1 hybrid bonds.

The first CoCo bond was issued in 2009, and there has been more than \$300 billion in CoCo bonds issued since then. A little more than half of these bonds allow regulators to write down the principal, and the remainder automatically converts into common equity upon 'trigger' events such as a low capital ratio.<sup>1</sup> Despite growth in the issuance of conventional CoCos, Islamic banks raising capital with sukuk have not yet used CoCo-type structures, although many Tier 1 sukuk use similar 'alternate' structures.

The CoCo bond is designed to address the situation facing many regulators during the financial crisis where the process of writing down debt would have taken longer than the time available to contain the immediate crisis. This presented regulators with the unappealing choice of pushing a bank into a disorderly bankruptcy or injecting public money to avoid contagion.

The distinguishing characteristic of a CoCo bond is that it may either be written down or converted into equity when the bank that issued it runs into financial difficulty, before any taxpayer financing is provided. The trigger for the write-down or conversion is either a determination by the bank's regulator or a quantitative trigger based either on book values (for example, the bank's Common Equity Tier 1 (CET1) capital ratio) or market values (the value of its common equity relative to its assets).<sup>2</sup>

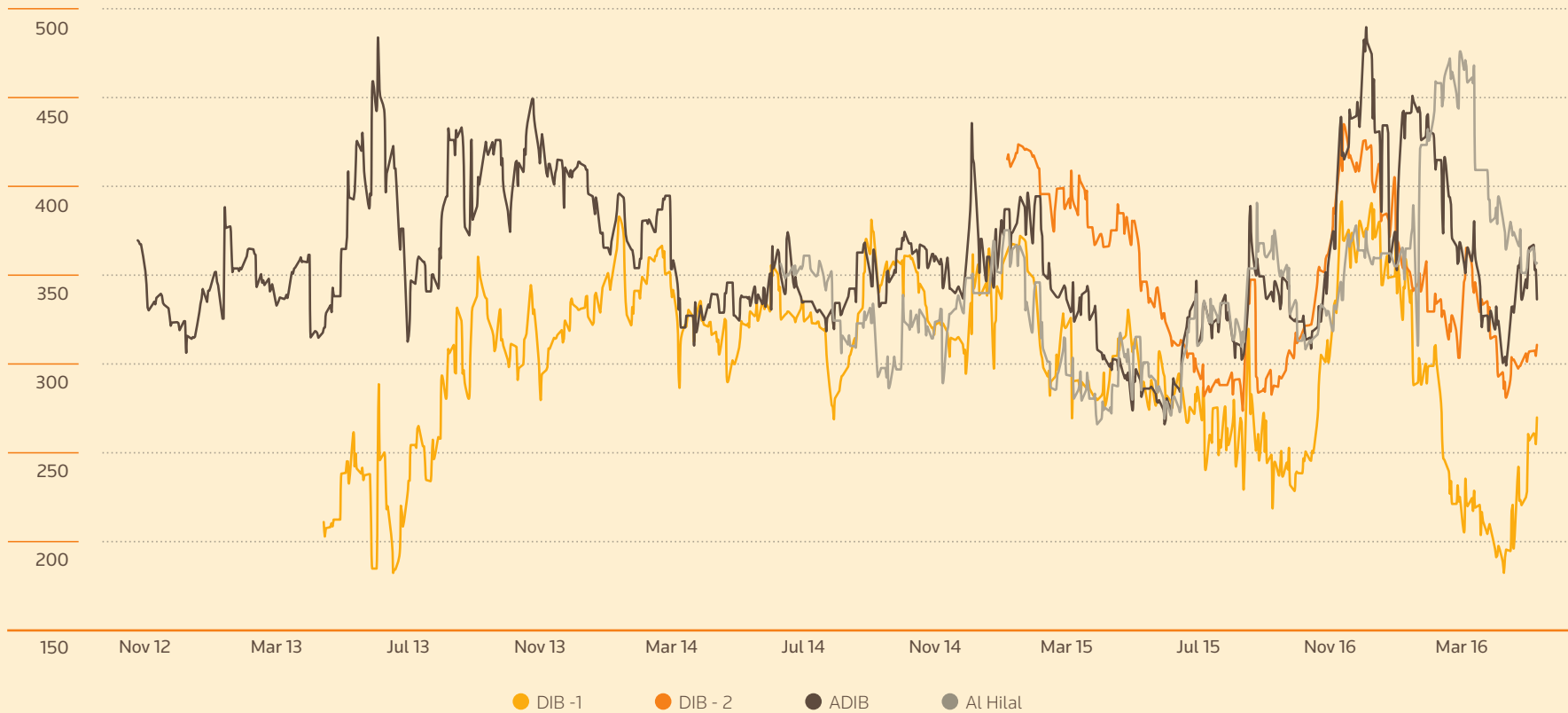
The Basel III reforms provided a third option, whereby financing provided in the form of Additional Tier 1 (AT1) non-CoCo issuance could act as capital to be used as a cushion, adding to common equity or absorbing losses and reducing contagion during a crisis. On the basis of the 'risk-sharing' principles of Islamic finance and sukuk in particular, this structure should be theoretically appealing to Islamic financial institutions.

However, this largely has not come to pass. No sukuk currently issued can fully be considered CoCo sukuk. There has been some development of similar AT1 sukuk that are compliant with Basel III that were issued to raise capital levels to support anticipated future asset growth. The first two were issued by Abu Dhabi Islamic Bank and Dubai Islamic Bank and most of the issuance to date has come from the UAE. Qatar Islamic Bank issued one in July 2015; Saudi Arabia saw a similar issuance from National Commercial Bank in December 2015 and Boubyan

<sup>1</sup> Vallée, Boris. "Contingent Capital Trigger Effects: Evidence from Liability Management Exercises," Working Paper, [http://www.hbs.edu/faculty/Publication%20Files/CallMeMaybe\\_Dec15\\_44855cde-b073-4003-b04e-d8f17fadf595.pdf](http://www.hbs.edu/faculty/Publication%20Files/CallMeMaybe_Dec15_44855cde-b073-4003-b04e-d8f17fadf595.pdf)

<sup>2</sup> Avdjiev, Stefan, Anastasia Kartasheva and Bilyana Bogdanova. "CoCos: A primer," *BIS Quarterly Review*, September 2013, 43-56. [http://www.bis.org/publ/qtrpdf/r\\_qt1309f.pdf](http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf)

## ADDITIONAL TIER 1 SUKUK SPREAD (BASIS POINTS)



Source: Thomson Reuters EIKON and authors' analysis

Note: In the chart above, the yield on the AT1 sukuk are taken and the yield on the comparable maturity government security (actual or extrapolated) for Abu Dhabi (Abu Dhabi Islamic Bank and Al Hilal Bank) or Dubai (Dubai Islamic Bank) is subtracted. The maturity date is assumed to be the year of the first call date. The securities used for comparison are Dubai Department of Finance (DOF) 2017 Sukuk, Dubai 2020 Bond, Abu Dhabi 2019 Bond, International Petroleum Investment Company (IPIC) 2017 Bond





Bank is finalizing its issuance of an AT1 sukuk in May 2016.<sup>3</sup>

Below is a chart showing the relative spreads of the AT1 sukuk, which trade with a 300-bps spread relative to the sovereign debt of Dubai or Abu Dhabi (for DIB and ADIB/Al Hilal, respectively). The spread is relatively wide due to the subordinated, equity-like features of the AT1 sukuk but has held at a relatively consistent level despite fears of a future rise in impaired financing driven by lower oil prices. Although the average spread has remained at a similar level, the volatility has increased as oil prices fell.

The general characteristics in the AT1 sukuk that align with the characteristics found with CoCo bonds are:

- they are perpetual issues (though most may be called after five years); and
- distributions are non-cumulative and may, at the discretion of the issuer, be skipped without triggering default.

The primary missing feature is the explicit conversion or write-down feature which, in some respects, is included as part of the point of non-viability (PONV) trigger common to all Tier 1 and Tier 2 bonds and sukuk.<sup>4</sup> Within the conventional CoCo issuance trends, there was a shift towards new bonds qualifying as AT1 capital beginning in 2012 as the Basel III implementation process was set to enter the beginning of the phase-in on January 1, 2013.<sup>5</sup>

For a financial institution to issue CoCo sukuk, it would likely start with the AT1 sukuk structure which is a mudarabah based on what is effectively a pro-rata share of the bank's entire asset base.<sup>6</sup> On this structure, the bank would then have to add a conversion feature to allow the entire sukuk to have a mandatory conversion into equity.

There have been a number of convertible sukuk (where the sukuk is convertible into shares of the issuer) and exchangeable sukuk (where the sukuk can be exchanged for shares of a company owned by the issuer). However, in these cases, the conversion feature is generally designed to be economically beneficial, which helps the functioning of the conversion feature.

The challenge with the conversion feature for CoCo sukuk, in contrast, is identifying a structure to:

1. Make it mandatory in a situation where the economic terms being offered are not economically preferable for the investors; and
2. Setting a fixed conversion price in advance to be tied to either the CET1 ratio or equity market capitalization to total assets.

These structural challenges, as well as challenges relating to pricing, have so far inhibited any CoCo sukuk issuances. However, with the volume of AT1 sukuk increasing, there may be an opportunity coming for an issuer to use a CoCo structure, particularly in jurisdictions where the Basel III implementation is moving forward, like Saudi Arabia, which is already compliant,<sup>7</sup> in the UAE, where the central bank has been working to implement Basel III during 2016,<sup>8</sup> and in Kuwait, which expects to be Basel III-compliant by the end of 2016.

3 Narayanan, Archana. "Qatar Islamic Bank raises 2 billion riyals with Tier 1 sukuk," *Reuters*, July 1, 2015. <http://www.reuters.com/article/qib-sukuk-idUSL8N0ZH0J20150701>  
Paul, Katie. "Saudi's National Commercial Bank (NCB) says settled issuance of 2.7 bln riyal sukuk," *Reuters*, December 23, 2015. <http://www.reuters.com/article/nationl-comm-bk-sukuk-idUSL8N14C1Z920151223>  
Roy, Sudip. "Kuwait Boubyan Bank tightens guidance on \$250 mln sukuk," *Reuters*, May 9, 2016. <http://www.reuters.com/article/boubyan-bank-sukuk-idUSL5N18658J>

4 Avdjiev et al. (2013).

5 Bank for International Settlements. 2013. "Basel III phase-in arrangements," [http://www.bis.org/bcbs/basel3/basel3\\_phase\\_in\\_arrangements.pdf](http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf)

6 For example, ADIB's 2012 AT1 sukuk offering document describes the mudaraba assets as (emphasis added): "ADIB shall be granted the express entitlement to commingle its own assets with the Mudaraba Assets and as a result, it may not be possible to identify the Mudaraba Assets separately from the assets of ADIB."

7 <http://www.bis.org/press/p150930.htm>

8 <http://www.reuters.com/article/emirates-basel-idUSL8N13Y20L20151209>



## Reasons for market volatility

### The drop in oil prices is considered the main reason for sukuk market volatility

All industry segments in our survey considered the drop in oil prices the main factor affecting sukuk issuance volumes, given that many of the leading respondents are from oil-exporting economies. There have been expectations that the revenue short-fall from such a drop will lead to more issuances in oil-exporting countries to meet current and capital spending needs. However, to date, there have instead been fewer sukuk issuances, as many governments chose instead to issue conventional bonds for ease and security. Oil-exporting governments have also reduced their financing needs through spending cuts, privatization of government assets and have used their account surpluses by withdrawing from local banks.

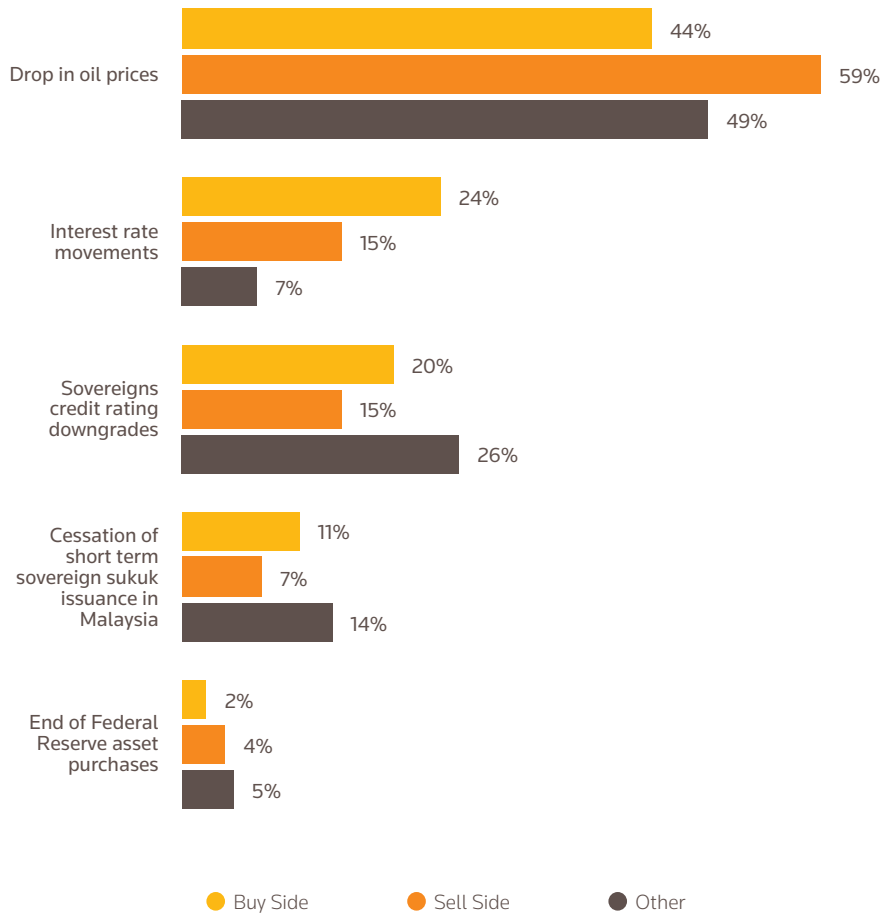
The drop in oil prices is also correlated with credit downgrades for some sovereigns such as the GCC nations. There is a divergence in outlook and ratings among GCC sovereigns based on their economic strength. Qatar, the UAE and Kuwait have stronger ratings compared to Oman, Bahrain and Saudi Arabia, which were downgraded lately. Oman is the weakest as hydrocarbons make up a very high proportion of its exports, despite its fiscal consolidation efforts. With oil prices remaining low, the deficits are expected to grow and further downgrades are expected. Malaysia, although it is considered the most important net energy exporter in the Asia Pacific region, has a more diverse economy, and the impact of low oil prices will be more modest on it.

As for interest rate movements, the anticipation of multiple Fed rate hikes in 2016 reduced the appetite for sukuk issuance towards the end of 2015. However, as this anticipation declined when the rate hikes were revised down into two rate increases, sukuk issuance has been expected to recover as issuers' concerns over rate rises have subsided. GCC currencies that are pegged to USD have been affected, as they need to match the Fed benchmark rates. The lower anticipation for rate hikes matches our survey respondents' lower concern that interest rate movements are a primary factor affecting sukuk volumes compared to the movement in oil prices.

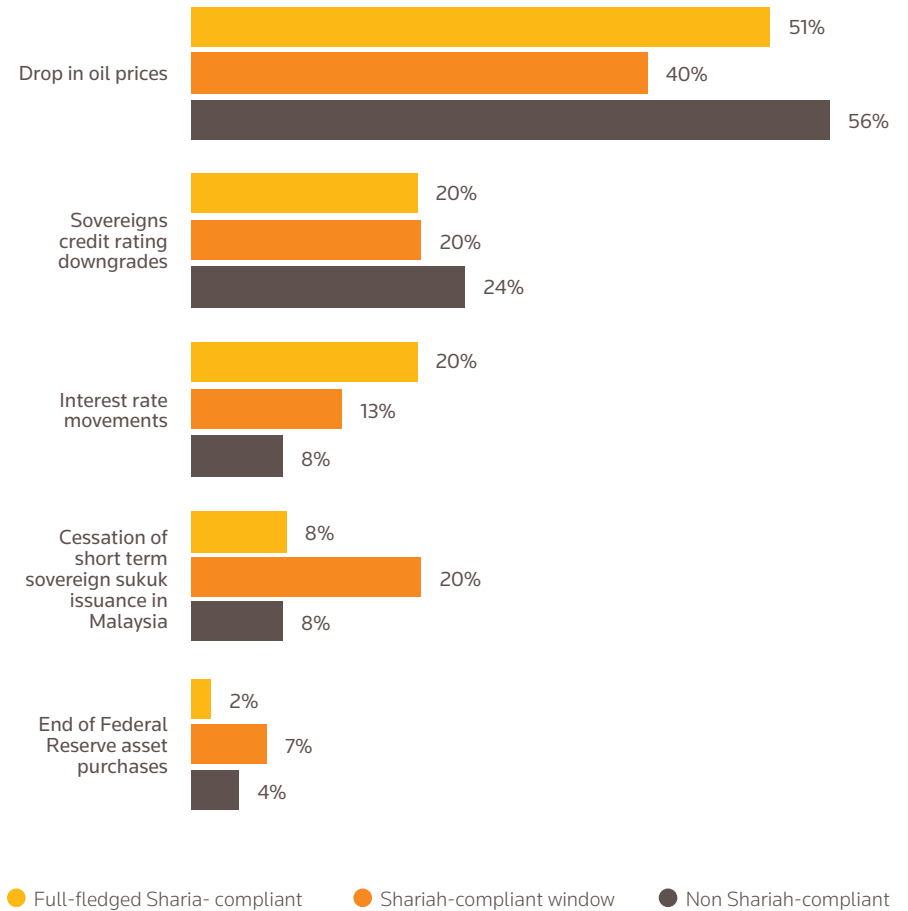
### GCC AND MALAYSIA SOVEREIGN CREDIT RATINGS

As of October 2016	Fitch		Moody's		S&P	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Bahrain	BB+	Stable	Ba2	Negative	BB	Stable
Saudi Arabia	AA-	Negative	A1	Stable	A-	Stable
Oman			Baa1	Stable	BBB-	Stable
UAE	AA	Stable	Aa2	Negative	AA	Stable
Qatar	AA	Stable	Aa2	Negative	AA	Stable
Kuwait	AA	Stable	Aa2	Negative	AA	Stable
Malaysia	A-	Stable	A3	Stable	A-	Stable

SURVEY FINDINGS – WHICH FACTOR IS PRIMARILY RESPONSIBLE FOR AFFECTING SUKUK ISSUANCE VOLUMES?



BY SHARIAH MANDATE – WHICH FACTOR IS PRIMARILY RESPONSIBLE FOR AFFECTING SUKUK ISSUANCE VOLUMES?

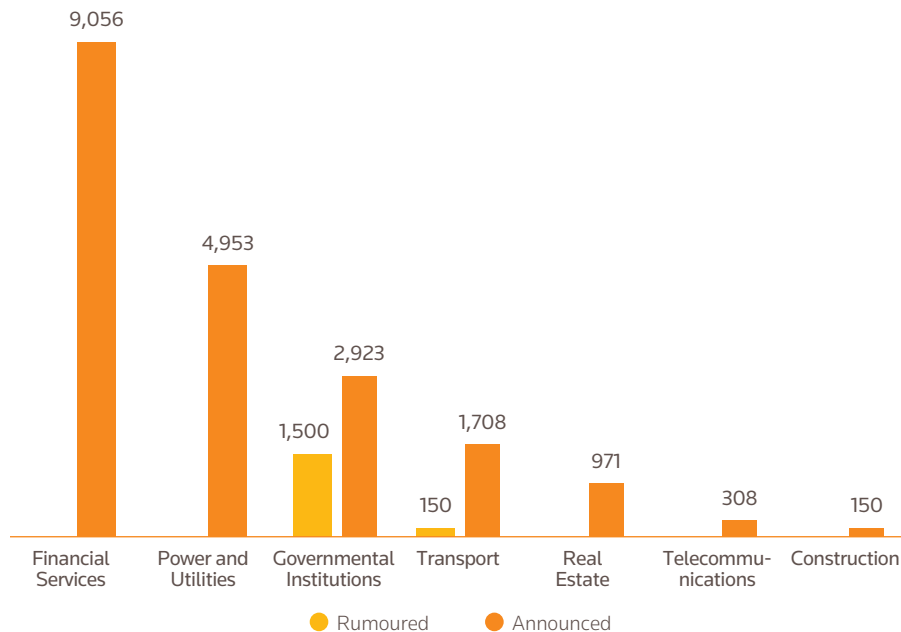


## Sukuk Pipeline

### Market uncertainty has led to a decreased sukuk pipeline by September 2016

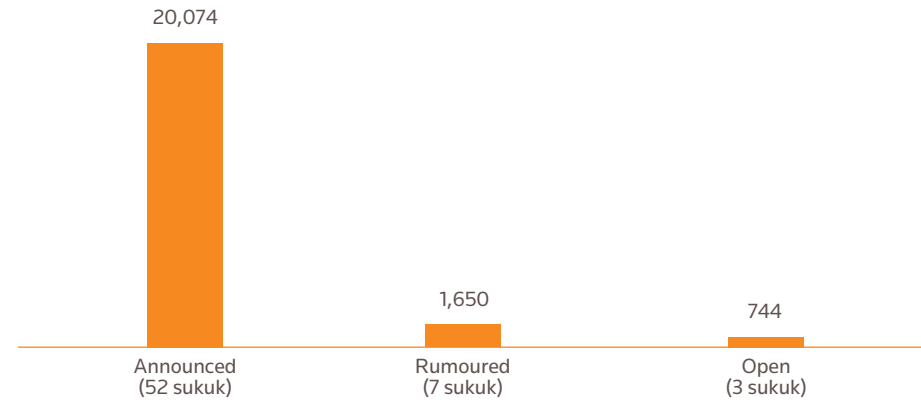
The sukuk pipeline (announced and rumored sukuk) as of September 2016 adds up to US\$22 billion which is less than the sukuk pipeline as of September 2015 that added up to US\$32 billion in total volume. Most of these sukuk are to be issued by financial institutions, which include Saudi’s Bank Al Bilad and Kuwait Finance House. The second largest sector on the pipeline is power and utilities which includes Malaysia’s Tenaga Nasional which plans to issue US\$2.5 billion in sukuk.

### SUKUK PIPELINE BY SECTOR (US\$ MILLION)



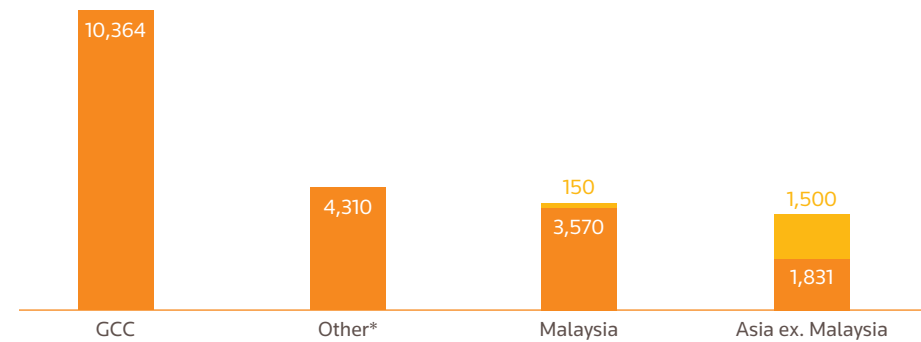
Source: Thomson Reuters

### SUKUK PIPELINE BY TOTAL VOLUME (US\$ MILLION)



Source: Thomson Reuters

### SUKUK PIPELINE BY TOTAL VOLUME (US\$ MILLION)



\* Other include Kenya, United States, Turkey, Libya, Niger, Tunisia, Jordan, Nigeria and Luxembourg

Source: Thomson Reuters

### New players are willing to tap into the sukuk market

On the bright side, the sukuk pipeline also includes new countries that are preparing to participate in this flourishing industry. Sovereign sukuk are currently planned in African countries such as Niger, Kenya and Nigeria. Other potential entrants include Kazakhstan and Jordan (which issued local currency US\$47.9 billion sukuk in October 2016). Between announced and rumored sukuk, there are 21 countries in the sukuk pipeline.

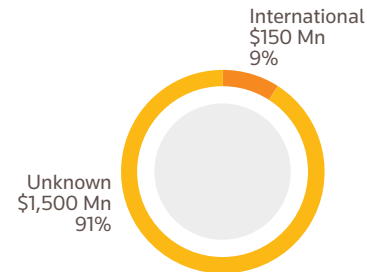
A plurality of the announced issues are international sukuk, but their size remains unknown. For rumored sukuk, the size is mostly unknown except for Chinese rumored sukuk, including HNA Group sukuk and China’s Ningxia region sukuk which are rumored to be US\$1.5 billion and US\$150 million in size. Both of the sukuk were rumored in 2015, but no further news about them has been released.

### SUKUK PIPELINE BY SIZE OF ISSUANCE

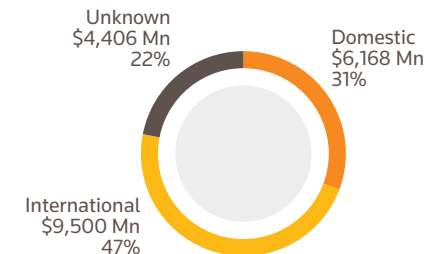
Size (US\$)	Number of sukuk	
	Announced	Rumoured
Unknown	19	5
>250 Mn	15	1
250 Mn-500 Mn	7	
500 Mn-750 Mn	2	
750 Mn-1 Bn	2	
1 Bn-1.25 Bn	2	
1.25 Bn <	5	1

Source: Thomson Reuters

### RUMOURED SUKUK BY MARKET OF ISSUE

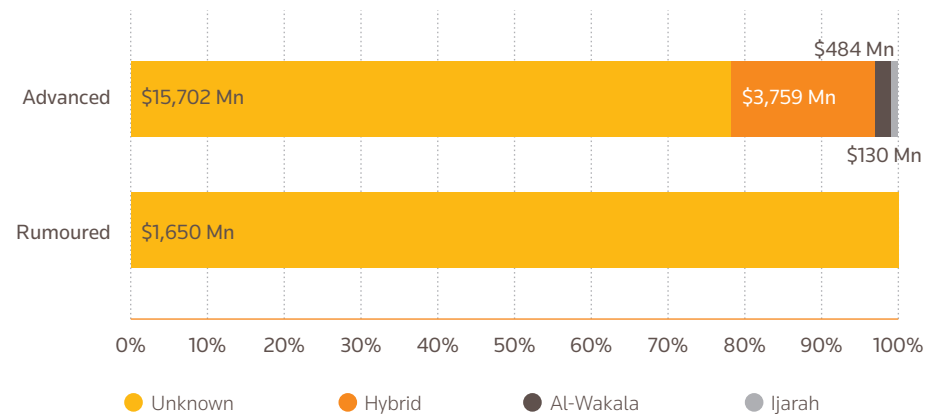


### ANNOUNCED SUKUK BY MARKET OF ISSUE



Source: Thomson Reuters

### SUKUK PIPELINE BY STRUCTURE



Source: Thomson Reuters

## Challenges facing issuers

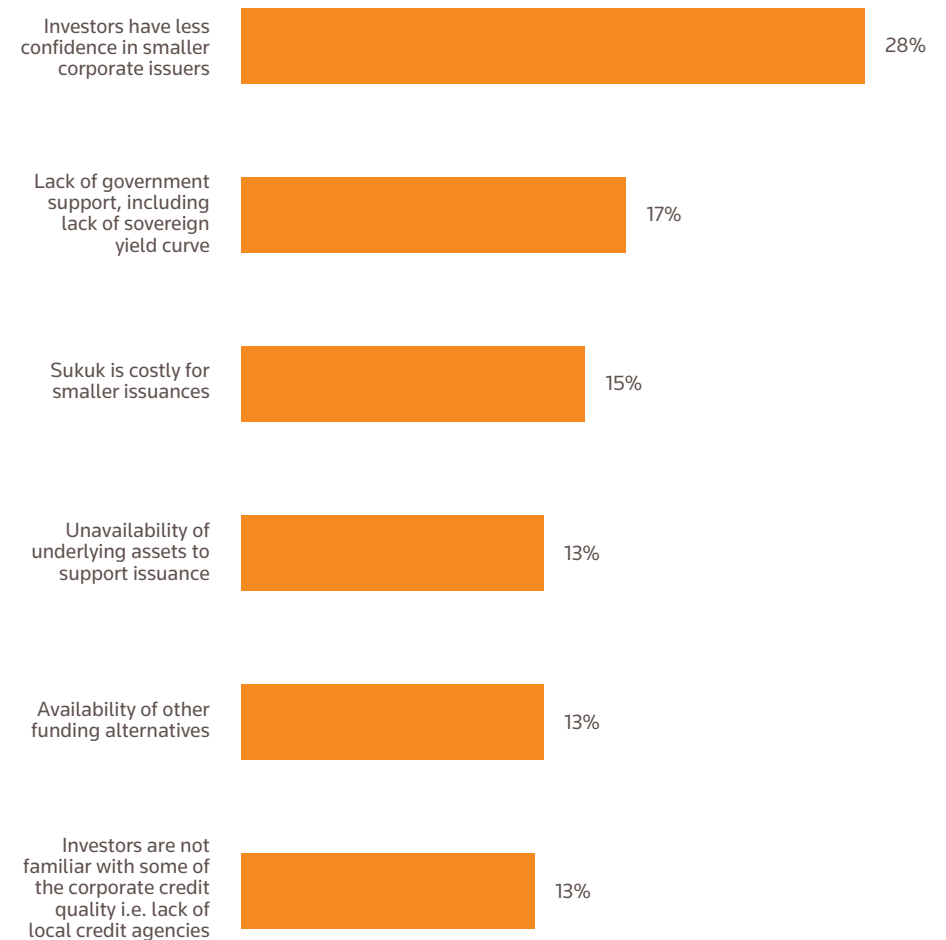
### Size remains a challenge facing corporate issuers

According to buy-side respondents, the main challenge for corporate sukuk issuers is their small size. Investors may not be familiar with these companies and would perceive them as risky investments compared to sovereign and quasi-sovereign issuers. This leads investors to have less confidence in these corporations, considering them high-risk borrowers, and in turn requiring relatively high yields on their sukuk — making sukuk issuances very costly for these corporations.

The second biggest hurdle cited by investors is the lack of government support represented by a lack of sovereign yield curve. With no benchmark sovereign yields available at different maturities, pricing corporations’ credit risk and their sukuk issuances is more complicated. However, with more governments such as Oman, Ivory Coast, Togo and Jordan beginning to issue sukuk, this is providing benchmark yields and gradually establishing a sovereign yield curve for sukuk issued in their countries. Consequently, the lack of a sovereign yield curve is unlikely to remain a major issue for corporate issuers for long.

The third challenge for corporate issuers is the high relative cost associated with smaller issuances. As previously mentioned, corporate issuers tend to be smaller in size, and would therefore have relatively small sukuk issuances. However, issuance costs in most cases are fixed, which means most corporate issuers are not able to capitalize on economies of scale to make the issuance process cost effective. Higher required yields from investors coupled with high issuance costs, are likely to deter corporations from issuing sukuk where bank lending might prove a cheaper funding option.

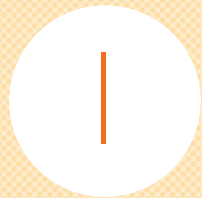
## SURVEY FINDINGS – THE SUKUK MARKET IS STILL DOMINATED BY SOVEREIGN ISSUERS, WHAT ARE THE MAIN HURDLES CORPORATE SUKUK ISSUERS ARE FACING?







# WILL BREXIT HELP BOOST ISLAMIC FINANCE AND SPECIFICALLY SUKUK?



In June 2016, the United Kingdom held a nationwide referendum on whether it should leave the European Union. This was a political pledge made by ex-Prime Minister David Cameron in 2013 to

help his party to secure the anti-European vote in the 2015 general election. British discontent with the influx of European immigrants in the early 2000s was on the rise, especially after the 2008 financial crash and a corresponding fall in living standards. Campaigners to leave the EU claimed that it was holding back the UK, that it imposed too many rules on businesses and charged billions of pounds in membership fees. They hoped the Leave vote would give the UK control of its borders back, and limit immigration in the future. The affirmative result of the referendum came as worldwide shock, as 52% voters elected to leave, and only 48% voted to remain. Analyst predictions of the implications of Brexit remain varied between all negative, all positive, and mixed. However, the impact on both the UK and the EU will depend on the terms of the UK's exit and whether it successfully negotiates an agreement with the EU governing their future relationship.

## **Brexit: short term hit to exports and financial services, potential for non-EU opportunities in the long run**

Assuming that the UK will be able to negotiate favorable exit terms, analysts expect it to experience a moderately negative impact in the short term, with the net impact in the long term being moderately positive. The IMF's most recent economic growth forecasts indicate expectations of a slowdown in both the British and European economies. Growth in the UK is expected to drop from 1.7% in 2016 to 1.3% in 2017, while EU growth is expected to be 1.6% in 2016, dropping slightly to 1.4% in 2017.

The trade and manufacturing sectors will likely be impacted by additional costs facing British exporters in the form of tariffs. It is probable that Brexit negotiations will reach favorable trade terms, as the value of UK exports to major EU economies (excluding Germany) exceeds the value of its imports from these countries, and breaking the free trade agreement would hurt these economies more than it would hurt the UK. Moreover, with British manufacturing 10% below pre-2008 levels, along with Europe's

diminishing importance in global trade, the UK could benefit from brokering trade agreements with third party/non-EU countries, and provide easier and quicker access to the UK market. Analysts agree that the financial services sector will be hit in the short term because of loss of access to the single market and loss of influence over the setting of regulations. However, as with trade, exiting the EU can create opportunities for the UK to attract more deals with emerging markets, generating returns in the long term.

## **United Kingdom the leader of Islamic finance in the Western world, industry in Europe still limited and fragmented**

The Islamic finance industry has progressed slowly in Europe since its establishment in the early 1980s. Europe's share of global Islamic financing assets, excluding those at non-Islamic banking institutions, accounted for just 0.5%.

Among European nations, the Islamic finance industry has developed strongly in the UK, and it now competes with the offerings of conventional banking institutions. The UK is a leader in Islamic finance in the

Western world, with over 20 banks in the UK offering Islamic financial services, of which five are wholly Shariah-compliant Islamic banks with assets totaling US\$3.6 billion in 2014.

The sukuk market is the major driver for Islamic finance in London, a major center for issuing and trading international debt instruments. As of November 2015, a total of US\$51 billion has been raised through 57 issues of sukuk listed on the London Stock Exchange (LSE). In addition, the UK was the first Western nation to issue a sovereign sukuk, selling £200 million in sukuk in 2014. The issue was oversubscribed, with very strong demand and orders totaling around £2.3 billion.

### **Islamic finance key to attracting foreign investment in infrastructure**

In Europe, Islamic financial products have been mainly used by corporations for liquidity management and as an alternative source of funding for investment projects. However, in the UK, Islamic finance has recently been playing an important role in the funding of infrastructure development projects. In 2008, a consortium of four Qatari Islamic banks

bought an 80% stake in London's Shard for GBP 4.1 billion, promising to provide at least the first tranche of financing for the project using commodity murabaha. Another example is the Olympic Village redevelopment project, a GBP 1.4 billion joint venture between Qatari Diar (the real estate arm of the Qatar Investment Authority). In addition, the UK Trade and Investment Department (UKTI) continues to promote Shariah-compliant funding for UK regeneration project developments.

Post-Brexit, the UK stands to lose assigned EU funding for some of its infrastructure and economic regeneration projects and will therefore be seeking alternative funding sources. The British government should strongly consider Islamic financial products, particularly Sukuk, to substitute lost EU funding, given its shifting focus towards Shariah-compliant funding. Both in the UK and the EU, infrastructure projects in sectors such as water, energy, transportation, manufacturing and information technology could potentially be funded with Islamic financial products such as sukuk. Recommended sukuk structures for these projects include: murabaha and salam

for the expansion of sector operations, istisna'a for future project construction and ijarah for leasing arrangements.

At present, issuing government bonds is the preferred choice for the UK and European governments to bridge their budget deficits. However, given their asset-based nature, sovereign sukuk could prove to be a lower-cost option for raising funds in debt markets. Also, the scarcity of highly rated sovereign sukuk can give it premium pricing compared to conventional bonds.

Expectations for slowing economic growth in the UK and Europe, coupled with bond purchase programs by central banks, should cause demand for bonds and sukuk to increase in a scramble for more secure assets and result in negative yields. However, foreign investors should still be interested in investing in fixed income instruments to achieve diversification. There is demand from private investors and sovereign wealth funds, in the Middle East and Asia, for Shariah-compliant investments in developed economies that are often not correlated with their home markets.

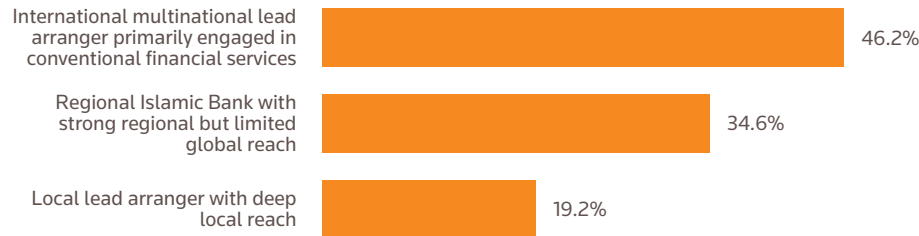
## Lead Arranger Preference

### Continued preference for international lead arrangers

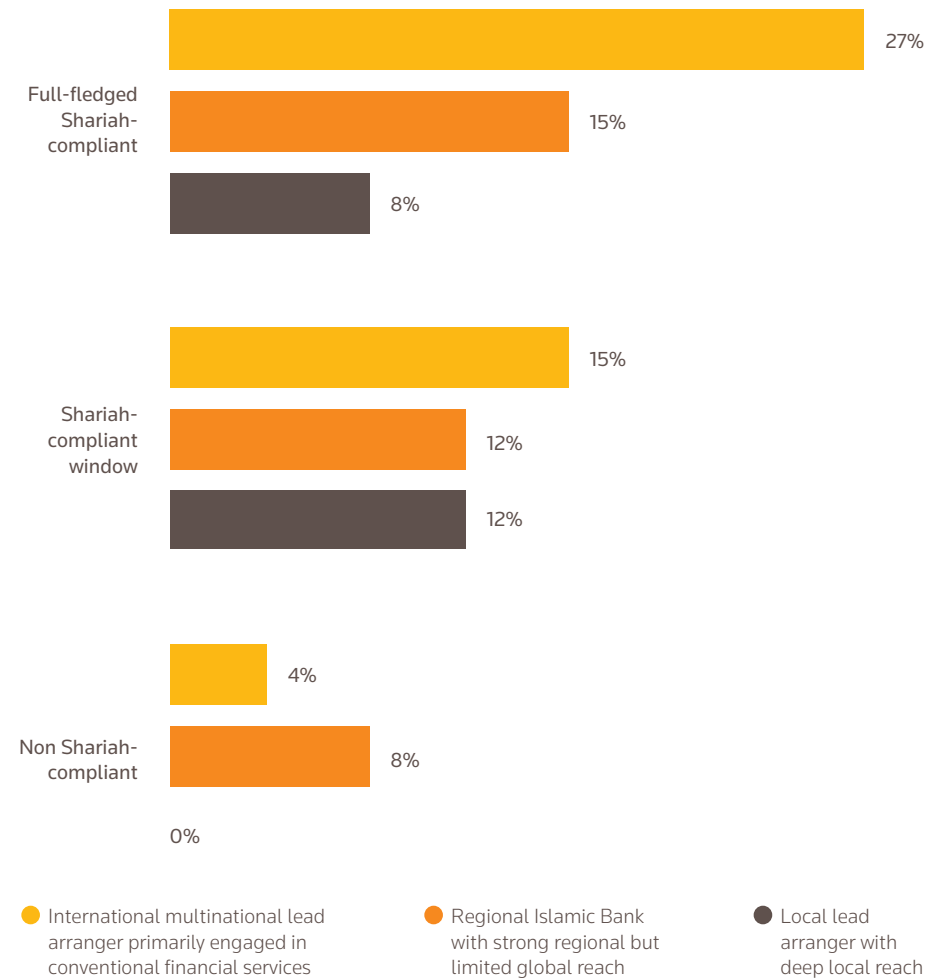
In line with last year’s results, almost half of respondents expressed a preference for international multinational issuers with extensive global networks. As issuers continue to seek alternative sources of funding outside the traditional markets in Malaysia and the GCC, international lead arrangers present a valuable opportunity for them to tap into global markets and access a broader investor base. The top three global sukuk lead arrangers for the first ten months of 2016 were Standard Chartered, with a 14.3% of market share by value issued, followed by HSBC (8.9%) and CIMB (8.2%).

On the other hand, 19% of respondents expressed a preference for local lead arrangers. This is likely the case because of a few reasons; in countries such as Malaysia and Indonesia the liquidity is higher in the local market. Domestic currency issuances dominate these markets, and given their susceptibility to high exchange rate volatility, international investors are less willing to invest in these sukuk. Moreover, Islamic financial institutions are generally smaller in size compared to their conventional counterparts. This leads them to prefer local and perhaps regional lead arrangers that can provide them access to local investors who are more familiar with their businesses and credit worthiness, therefore accepting lower returns.

### SURVEY FINDINGS – WHAT TYPE OF LEAD ARRANGER WOULD YOU PREFER?



### BY SHARIAH MANDATE – WHAT TYPE OF LEAD ARRANGER WOULD YOU PREFER?



## LEAD ARRANGERS AS OF OCT 31, 2016

Rank	Book Runner	Arranging	Market Share	Number of Issues	Rank	Book Runner	Arranging	Market Share	Number of Issues
1	Standard Chartered PLC	2,997.7	14.3	18	27	Societe Generale	145.0	.7	2
2	HSBC Holdings PLC	1,858.5	8.9	16	28	Bank of Sharjaya PLC	142.9	.7	2
3	CIMB Group Sdn Bhd	1,718.5	8.2	7	29	Kuwait Finance House	135.0	.6	3
4	Dubai Islamic Bank PJSC	1,415.7	6.8	13	30*	Riyadh Bank Ltd	133.3	.6	1
5	Emirates NBD PJSC	1,407.6	6.7	14	30*	Banque Saudi Fransi	133.3	.6	1
6	JP Morgan	1,159.3	5.5	5	30*	Sambacapital	133.3	.6	1
7	Citi	1,145.6	5.5	6	30*	GIB Capital	133.3	.6	1
8	Deutsche Bank	986.7	4.7	4	34	Barwa Bank QSC	124.3	.6	1
9	Malayan Banking Bhd	524.3	2.5	3	35	DIB CAPITAL Ltd	120.0	.6	1
10	Noor Bank	435.3	2.1	5	36	QInvest LLC	115.2	.6	2
11	Arab Banking Corporation	413.9	2.0	7	37*	National Bank of Sharjah	100.0	.5	1
12	BNP Paribas SA	387.5	1.9	2	37*	Commerzbank AG	100.0	.5	1
13	Bank Al-Jazira	326.7	1.6	1	39	Al Hilal Islamic Bank	93.8	.5	1
14	First Gulf Bank	299.8	1.4	4	40	Credit Agricole CIB	83.7	.4	2
15	Boubyan Bank	275.0	1.3	3	41	Union National Bank of UAE	83.3	.4	1
16	National Bank of Abu Dhabi	274.8	1.3	3	42*	Al-Muthanna Investment Co	71.4	.3	1
17	Credit Suisse	266.7	1.3	2	42*	ABC Bank	71.4	.3	1
18*	DBS Group Holdings	250.0	1.2	1	44	Qatar National Bank	55.6	.3	1
18*	Goldman Sachs & Co	250.0	1.2	1	45	AMMB Holdings Bhd	54.4	.3	1
20	Barclays	220.0	1.1	2	46	RHB	50.0	.2	1
21*	Gulf International Bank	214.3	1.0	1	47	National Bank of Oman Ltd	44.5	.2	1
21*	Natixis	214.3	1.0	1	48*	Abu Dhabi Islamic Bank (ADIB)	43.8	.2	1
23	Noor Islamic Bank	208.9	1.0	3	48*	KIPCO Asset Management Co	43.8	.2	1
24	MashreqBank PSC	207.6	1.0	2	50	National Bank of Kuwait SAK	35.7	.2	1
25	Agricultural Bank of China	200.0	1.0	1	-	<b>Subtotal with Book Runner</b>	<b>20,939.5</b>	<b>100.0</b>	<b>36</b>
26	Sinopac Holdings	183.7	.9	1					

Source: Thomson Reuters



## Global Sukuk Demand

### Reasons to invest in sukuk

#### Diversification leads main reasons to invest in sukuk

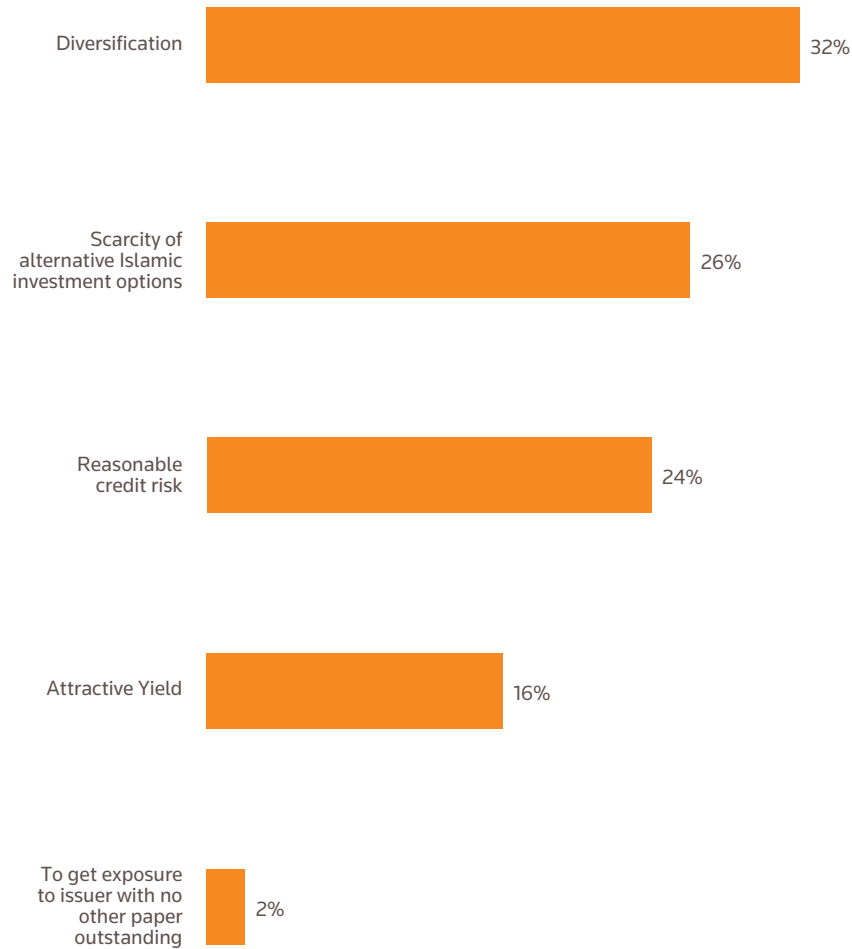
In the survey results on investor preferences for sukuk, there is no overwhelming single factor. Many investors chose diversification as a reason for investing in sukuk, as other assets such as equities or real estate are deemed riskier, especially in a period of dropping oil prices, and sukuk can add needed diversification to their portfolios. This was the leading opinion among both full-fledged Shariah-compliant investors and non-Shariah-compliant investors who can also choose conventional bonds and non-Shariah compliant assets for their investments.

The second most common response was the scarcity of alternative Islamic investment options, given that other Shariah-compliant assets are riskier and more volatile, such as equities. With a lower supply of sukuk in 2016, there will be a correspondingly higher

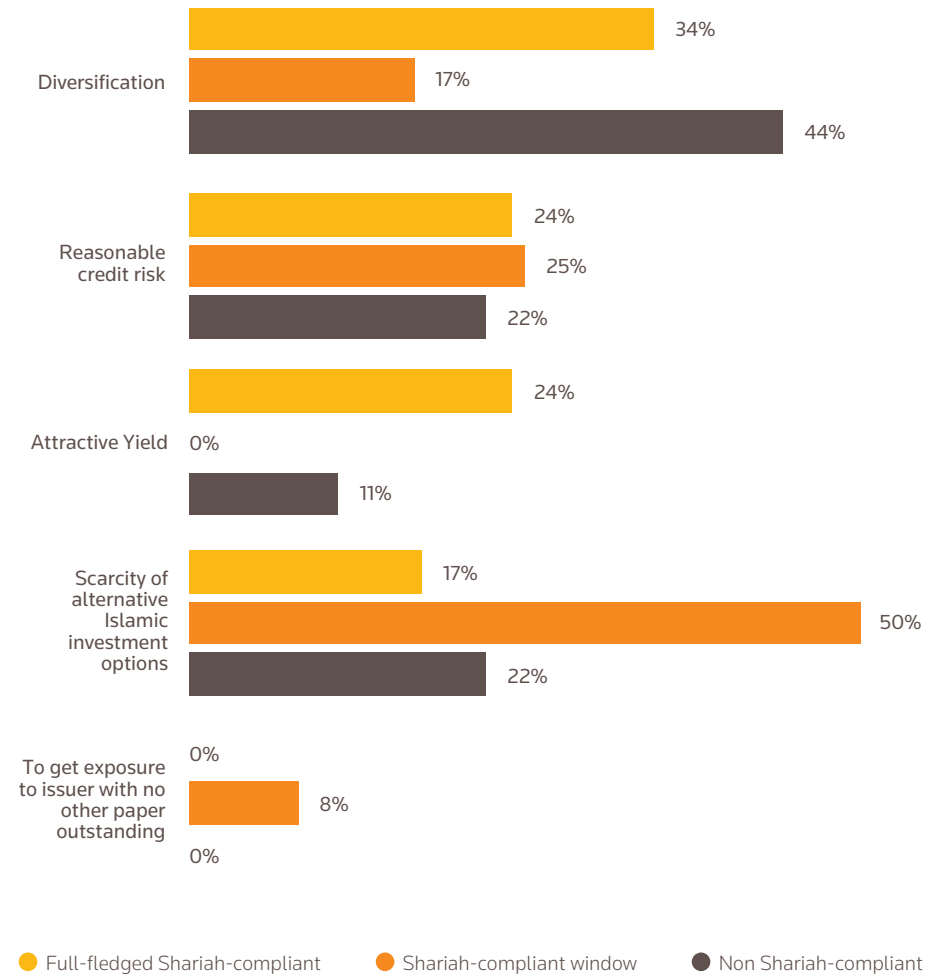
demand from investors with Shariah-compliant mandate. Shariah-compliant window investors agreed with this assessment.

24% of survey respondents feel that their reasonable credit risk is another important reason for investing in sukuk. As the pool of negative yield debt offered by many countries' central banks such as Germany and Japan is growing, there are few investment opportunities globally. That is why many survey investors believe that the only way that they could match their risks with returns is through investing in emerging market debt, including sukuk, which has a reasonable credit risk. Attractive yield, which is the second least chosen option, is being challenged with the prospects of another Federal Reserve interest rate increase which could increase reinvestment risk.

SURVEY FINDINGS – WHAT IS YOUR MAIN REASON FOR INVESTING IN SUKUK?



BY SHARIAH MANDATE – WHAT IS YOUR MAIN REASON FOR INVESTING IN SUKUK?





## Sukuk allocation

### Increasing appetite for sukuk investments

The preferences of buy side respondents have shifted since last year, signaling a willingness to allocate a higher proportion of their Islamic assets to sukuk. Where 45% of respondents were only willing to allocate less than 5% last year, this is the preference for only 20% of respondents this year. This means 25% of respondents are now willing to make higher allocations of sukuk in their portfolios: 20% of respondents are now willing to allocate over 50% of their portfolios to sukuk compared to none last year. The largest segment of investors (36%) is willing to allocate 5% to 24.9% to sukuk next year.

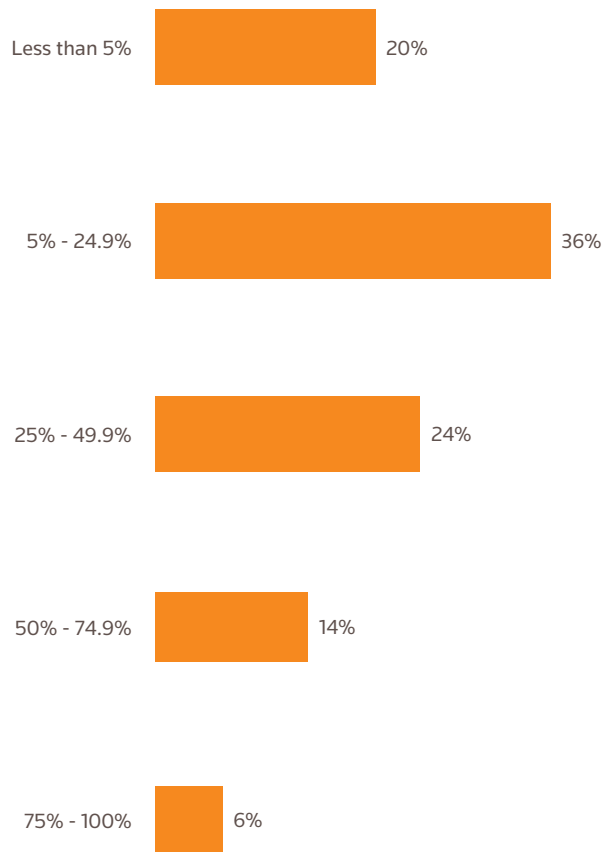
Since last year, the undersupply of sukuk in the market has driven many Islamic financial institutions, mainly Islamic banks and takaful operators, to seek alternative investments for their portfolios, such as real estate, equities and Islamic funds. However, these institutions are increasingly investing in sukuk, given that Shariah-compliant investment options available to them are limited, and sukuk would take preference among these investments.

Over half of buy-side respondents still prefer to allocate amounts less than US\$25 million, to sukuk, in line with 2015 findings. The biggest drop was in respondents will-

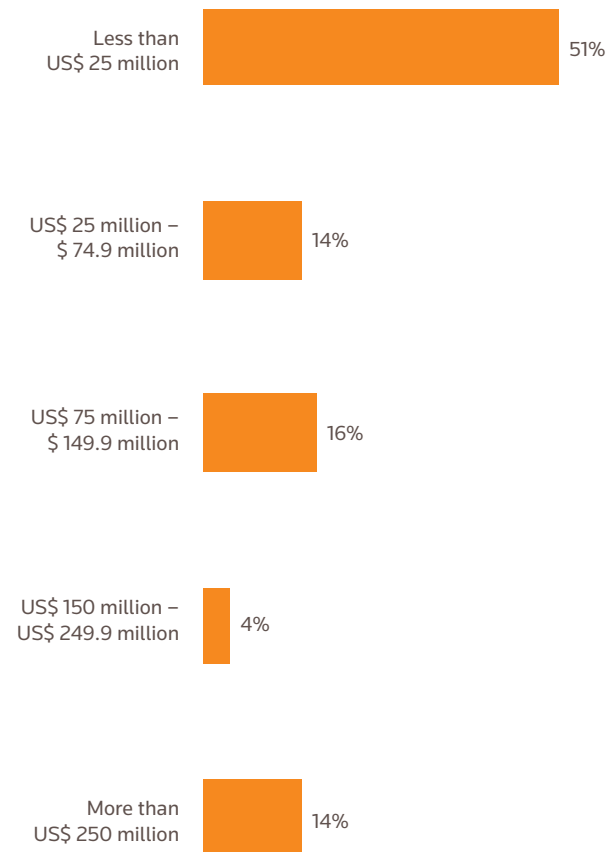
ing to allocate US\$25 million to US\$74.9 million; only 14% of investors preferred this compared to 30% last year. In line with their preferences for percentage allocations, there was an increase in investors willing to allocate amounts exceeding US\$75 million to sukuk. In particular, the proportion of investors planning to allocate over US\$250 million has jumped to 14%, from 2% last year.

Shariah-compliant and window institutions' allocation preferences are spread out across the different levels, with the majority willing to allocate less than US\$25 million. The increase in preference for higher allocations to sukuk signals that demands for sukuk is currently strong, especially considering the lack of supply in the market. Islamic financial institutions will allocate larger amounts of their portfolios to sukuk; it is the lowest-risk investment option that is available to them. However, most of them prefer the allocation of small amounts, an indication of small investment portfolios rather than smaller percentage allocations overall. Alternatively, non-Shariah-compliant institutions have a broader range of investments available to them, and as they become more familiar with the sukuk market, they are beginning to include them in their portfolios for the purpose of diversification, explaining their preference for smaller allocations.

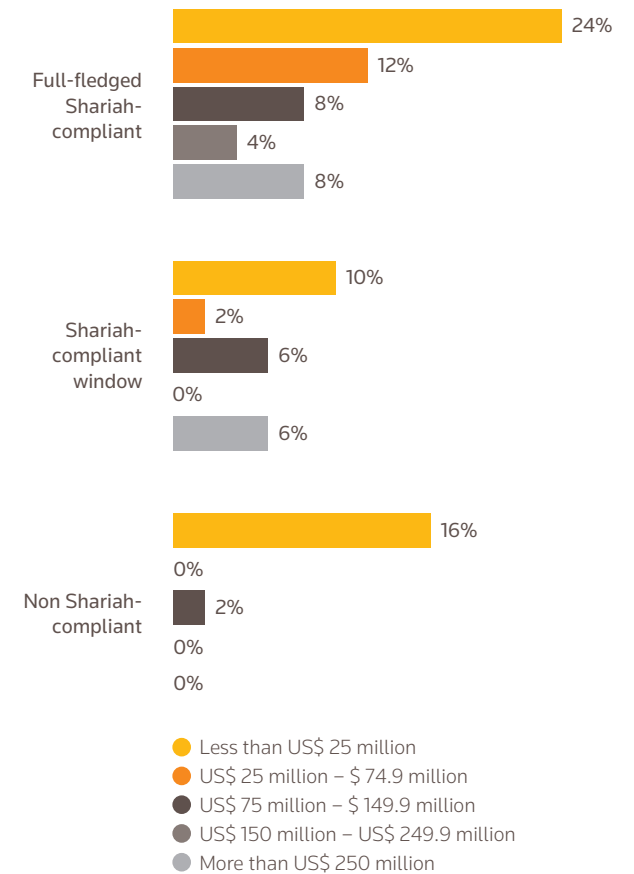
FOR THE REST OF 2016 AND 2017, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK (PERCENTAGE)?



FOR THE REST OF 2016 AND 2017, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK (VALUE)?



BY SHARIAH MANDATE – FOR THE REST OF 2016 AND 2017, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK (VALUE)?





An overall view shows the trading floor during midday trading at Frankfurt's stock exchange. REUTERS/KAI PFAFFENBACH

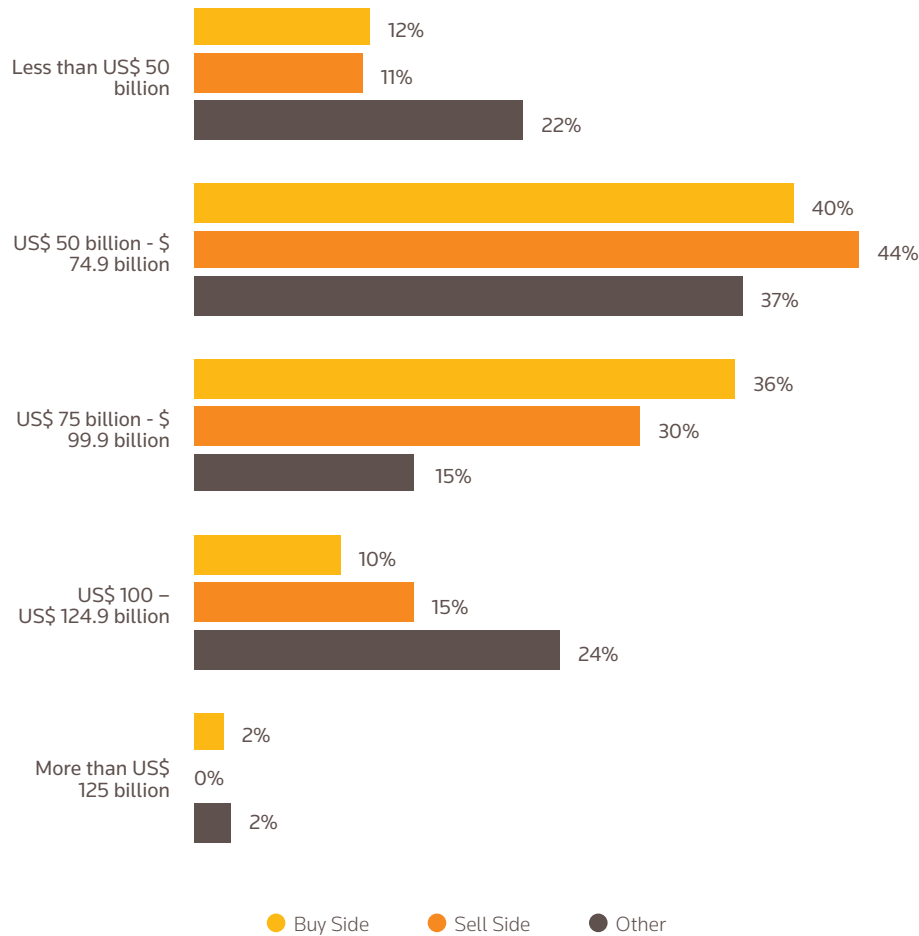
## Sukuk Volume Outlook

### Expectations for increased sukuk issuances in 2017

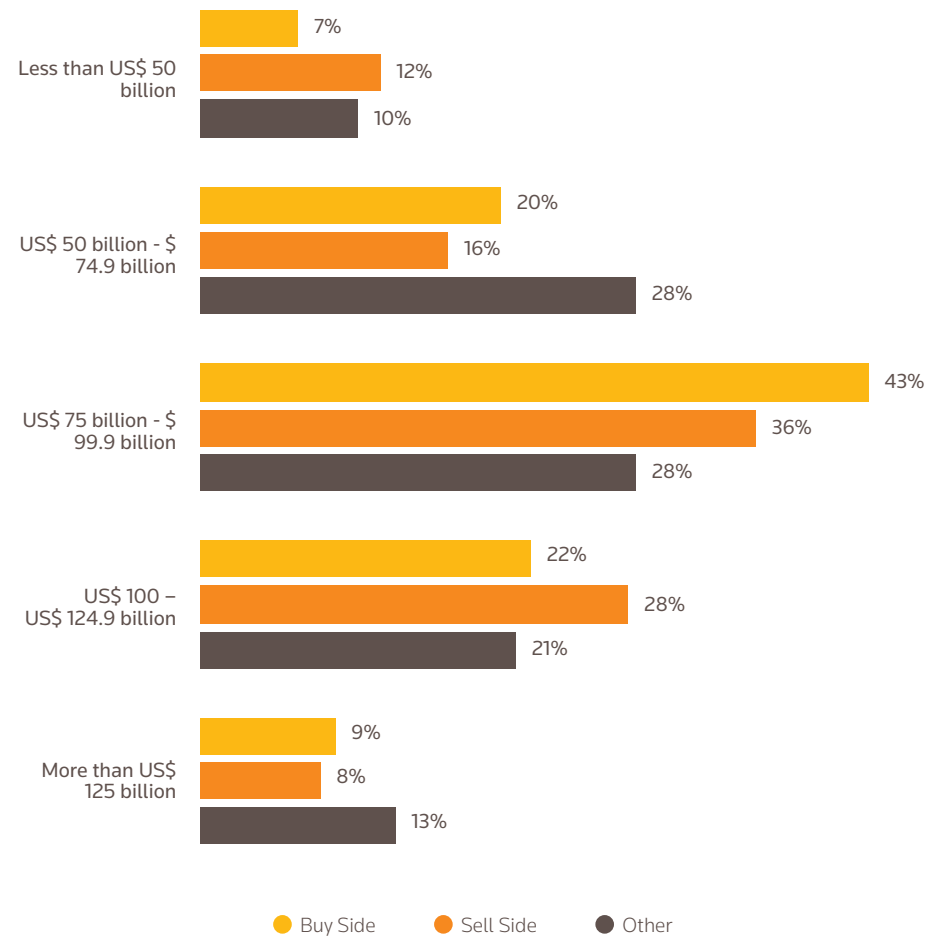
Most of the survey respondents believe the total sukuk amount issued in 2016 will range between US\$50-74.9 billion. This is a result of the low amount issued in 2015 and the persisting economic conditions in 2016, such as low oil prices and BNM's withdrawal from the market. Another reason is that some traditional issuers such as GCC countries are depending on alternative funding instruments such as bonds instead of sukuk.

However, most of the survey respondents are also optimistic and feel that things will turn around in 2017 and exceed \$75 billion. With the anticipated end of negative yields offered by European markets, bond investors will return to the European markets for new investments and the demand for conventional bonds in the emerging markets such as the GCC will decline. This leaves an opportunity for potential issuers to issue sukuk to meet the demand of Shariah-compliant investors given the low supply of sukuk.

SURVEY FINDINGS – WHAT VOLUME OF GLOBAL SUKUK ISSUANCE DO YOU EXPECT IN 2016?



SURVEY FINDINGS – WHAT VOLUME OF GLOBAL SUKUK ISSUANCE DO YOU EXPECT IN 2017?



## Sukuk Demand and Supply Equilibrium

### Market Outlook: Supply and Demand Model Assumptions

#### Sukuk demand gap to further widen as issuance slowdown persists

##### SUPPLY SIDE

In 2016, the supply of new sukuk fell a further 18% from 2015 as a result of a drop in GCC sovereign issuances. GCC governments have turned increasingly to conventional bonds to fund their fiscal deficits, while BNM's decision to cut short-term issuances continued to hold back sukuk issuance in Malaysia, the largest sukuk market globally.

The value of global sukuk issued in year-to-date Q3 2016 was US\$39.8 billion.<sup>1</sup> Based on our Supply and Demand model, sukuk issuances were on pace to reach around US\$48.8 billion by the end of 2016.

These figures are well below market expectations. Even though our Sukuk Survey respondents in last year's report were bearish about growth in global sukuk supply, 2016 figures as realized have fallen behind these expectations. This year's Sukuk Survey respondents expect issuance for the full year 2016 to fall between US\$50 – 75 billion, down from their 2015 prediction of US\$100-125 billion. As for 2017, respondents expect issuances to be between US\$75-100 billion in total.

Global sukuk issuance has declined at a CAGR of -11% between 2011 and 2016, despite greater than 50% growth in 2011 and 2012. However, new issuances dropped 36% in 2015 and the slide has continued in 2016. In last year's report, we projected sukuk

issuance growth would pick up in 2016, achieving growth of 15%, based on expectations that oil-producing countries would begin issuing sukuk to cover their budget deficits. These expectations were curbed; sovereign issuers this year have instead preferred to issue conventional bonds rather than sukuk. Accordingly, we have revised our growth projections for sukuk, estimating total issuances in 2016 will decline by 25%.

We expect issuances to finally pick up in 2017, growing 10% as the market for bonds issued by governments of oil-exporting countries begins to saturate. This should prompt these governments to start issuing sukuk to cover their deficits and to tap into the increasing demand from Islamic investors. We project this growth will remain steady over the next 4 years, 2018 to 2021, in line with the expected growth of Islamic finance assets.

Sukuk is the second largest asset class in Islamic finance, accounting for 17% of total Islamic finance assets. Outstanding sukuk is projected to continue growing at an average of 5% per year to reach US\$420.9 billion by 2021, although its share of total Islamic finance assets will decline to 14% because of the faster pace of Islamic banking growth.

Per our estimates, an average 25% of all sukuk between 2011 and 2016 were short-term instruments that were issued and matured in the same year.

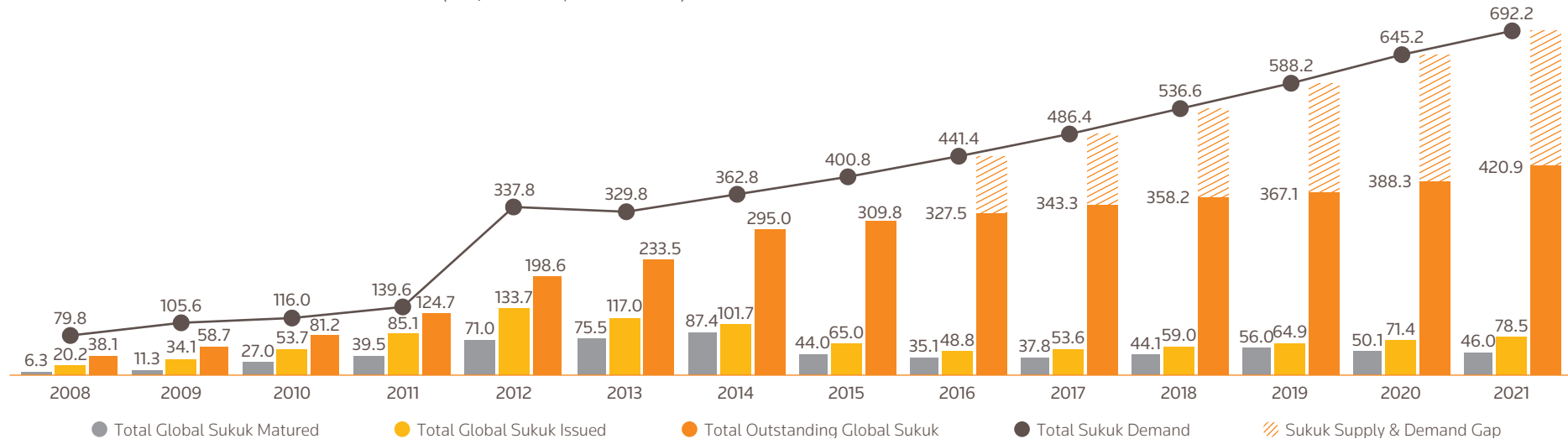
<sup>1</sup> All market data and estimates unless otherwise stated is the work of Thomson Reuters.



SUKUK SUPPLY AND DEMAND GAP EXPECTED TO WIDEN AS THE DECLINE IN SUKUK ISSUANCE CONTINUES

	2008	2009	2010	2011	2012	2013	2014	2015	2016F	2017F	2018F	2019F	2020F	2021F
Percentage Sukuk Growth	-48%	69%	57%	58%	57%	-13%	-13%	-36%	-25%	10%	10%	10%	10%	10%
Total Global Sukuk Issued	\$20.2	\$34.1	\$53.7	\$85.1	\$133.7	\$117.0	\$101.7	\$65.0	\$48.8	\$53.6	\$59.0	\$64.9	\$71.4	\$78.5
Total Global Sukuk Matured	\$6.3	\$11.3	\$27.0	\$39.5	\$71.0	\$75.5	\$87.4	\$44.0	\$35.1	\$37.8	\$44.1	\$56.0	\$50.1	\$46.0
Total Global Sukuk Outstanding	\$38.1	\$58.7	\$81.2	\$124.7	\$198.6	\$233.5	\$295.0	\$309.8	\$327.5	\$343.3	\$358.2	\$367.1	\$388.3	\$420.9
Total Sukuk Demand	\$79.8	\$105.6	\$116.0	\$139.6	\$337.8	\$329.8	\$362.8	\$400.8	\$441.4	\$486.4	\$536.6	\$588.2	\$645.2	\$692.2
Sukuk Supply & Demand Gap	\$41.7	\$46.9	\$34.8	\$14.9	\$139.2	\$96.3	\$67.8	\$91.0	\$113.9	\$143.1	\$178.4	\$221.1	\$256.9	\$271.3

SUKUK DEMAND & SUPPLY LEVELS (US\$ BILLION, 2016 – 2021)



## DEMAND SIDE

Two types of investors drive the demand for sukuk: Shariah-sensitive investors, as well as other global investors seeking diversification and attractive yields. We project the demand from Islamic financial institutions (IFIs)—the broadest group of Shariah-sensitive investors—as the foundation for continued sukuk investment.

According to data from the ICD Thomson Reuters Islamic Finance Development Indicator (IFDI2016), the total Islamic finance assets of banks, takaful, other Islamic financial institutions, funds and sukuk were valued at \$2 trillion in 2015.

IFDI2016's growth projection for Islamic finance assets up to 2021 is based on calculating the average weighted growth for each of the sectors or asset classes from 2012 to 2015 separately, then adding them to reach the projected total Islamic finance assets for each of following years. The growth rate for each asset class is calculated using the average growth for each country weighted by their contribution to the asset class' total assets (removing any foreign exchange effect), and adjusting the growth rate based on different economic factors such as oil prices. In this model, Islamic finance assets are projected to reach US\$3.5 trillion by 2021, based on an average annual growth rate of 10% from 2016.

Islamic banking is the main driver behind Islamic finance growth. It held 73% of total Islamic finance assets in 2015, which is projected to expand by 11-12% per year to reach 80% or US\$2.8 trillion by 2021.

According to IFDI2016, liquid assets make up only 16% of total Islamic finance assets, of which sukuk represent approximately 10%. Of the 84% of Islamic finance assets that are non-liquid, we estimate that sukuk account for a 5% (based on HTM classification).

Demand for sukuk estimated by our model equals 20% of the value of total Shariah-compliant assets, and the model assumes this demand will grow in line with the overall growth of Islamic finance assets. This value includes both Shariah-compliant and conventional investor portfolios allocation to sukuk.

We estimate that Shariah-sensitive investors' portfolio allocations to sukuk will account for 80% of demand, or 16% of the value of total Shariah-compliant assets. As for non-Shariah-compliant investors, consisting of mostly non-OIC markets such as the United States, Europe and Asia, we estimate their sukuk allocation will account for 20% of demand, which is valued at 4% of total Shariah-compliant assets worldwide.

## CHAPTER 4

# Secondary Market Performance



^  
Flying display and aerobatic  
show of the DHL Twisters  
in Bahrain International  
Airshow at Sakhir Airbase,  
Bahrain. DR AJAY KUMAR  
SINGH / SHUTTERSTOCK.COM

## Reasons for low liquidity

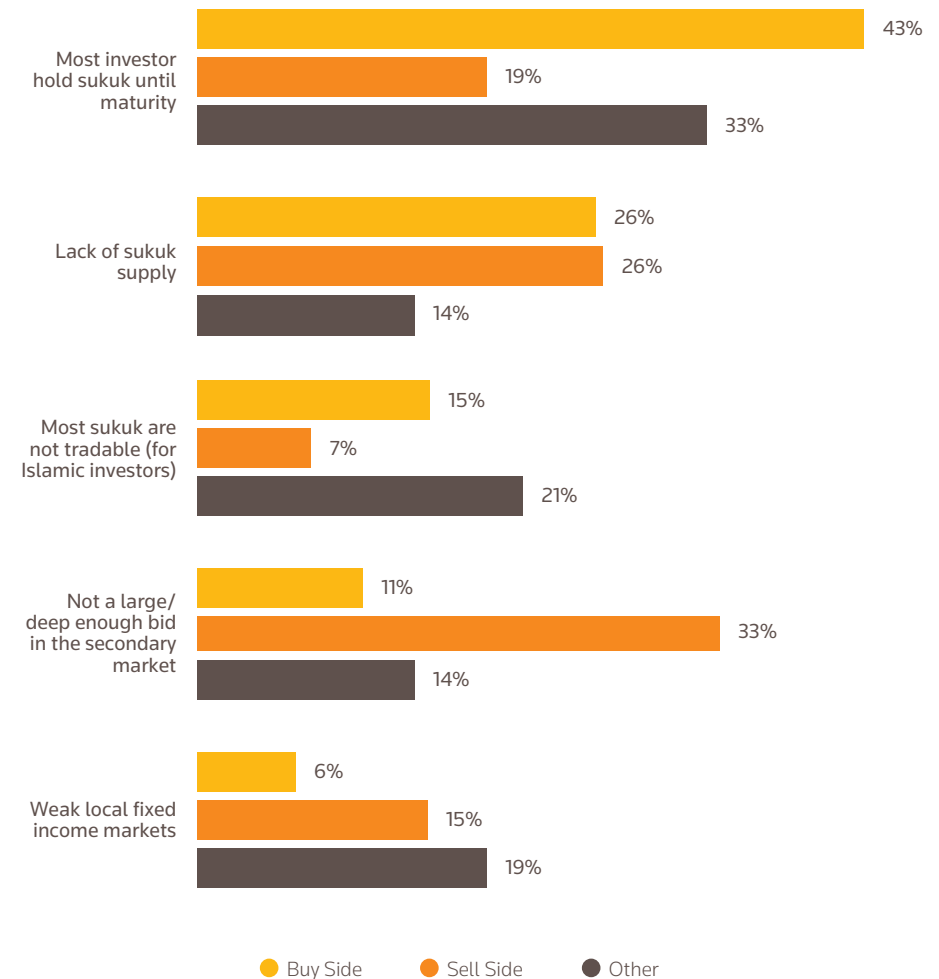
### Limited sukuk supply main driver for lack of liquidity and tradability

Buy-side and sell-side opinions in our survey differ on the main cause behind the lack of liquidity and tradability in the sukuk market. However, the reasons cited by both sides are ultimately driven by the shortage in the supply of sukuk in the market. The top reason cited by buy-side and other respondents is that most investors in the market hold sukuk to maturity. Generally, Islamic financial institutions invest more heavily in sukuk compared to other non-Shariah-compliant investors, as the former are limited to Shariah-compliant investments. They are more likely to hold their sukuk investments to maturity. Once these sukuk are sold, replacing them in the portfolio would be challenging because of lack of supply. This in turn leads lower liquidity and tradability in the market.

From the sell-side perspective, the primary reason for poor liquidity in the secondary market is the insufficient depth of bids in the sukuk market. This can be attributed to the significant drop in sukuk issuances since 2014. This is a result of BNM suspending short-term issuances in Malaysia and the drop in sovereign issuances from GCC countries that have recently shown a preference for conventional bonds. This has substantially reduced the supply of sukuk in the primary market and led investors in the secondary market to hold onto their sukuk investments till maturity, thus drying up liquidity.

The second most cited cause by the overall sample is the lack of sukuk supply. As our analysis shows, this is the root cause for poor liquidity and tradability in the market. With demand in the market not met with adequate supply, as evidenced by the consistent oversubscriptions of new issuances, investors are unlikely to trade their investments on the secondary market. This means there are even fewer sukuk available to trade in this market, resulting in unfavorable liquidity and tradability.

## SURVEY FINDINGS – WHAT IS THE MAIN REASON FOR LOW LIQUIDITY AND TRADABILITY IN THE MARKET?





People walking along the subway in Paris, France.

## Tenor Preference

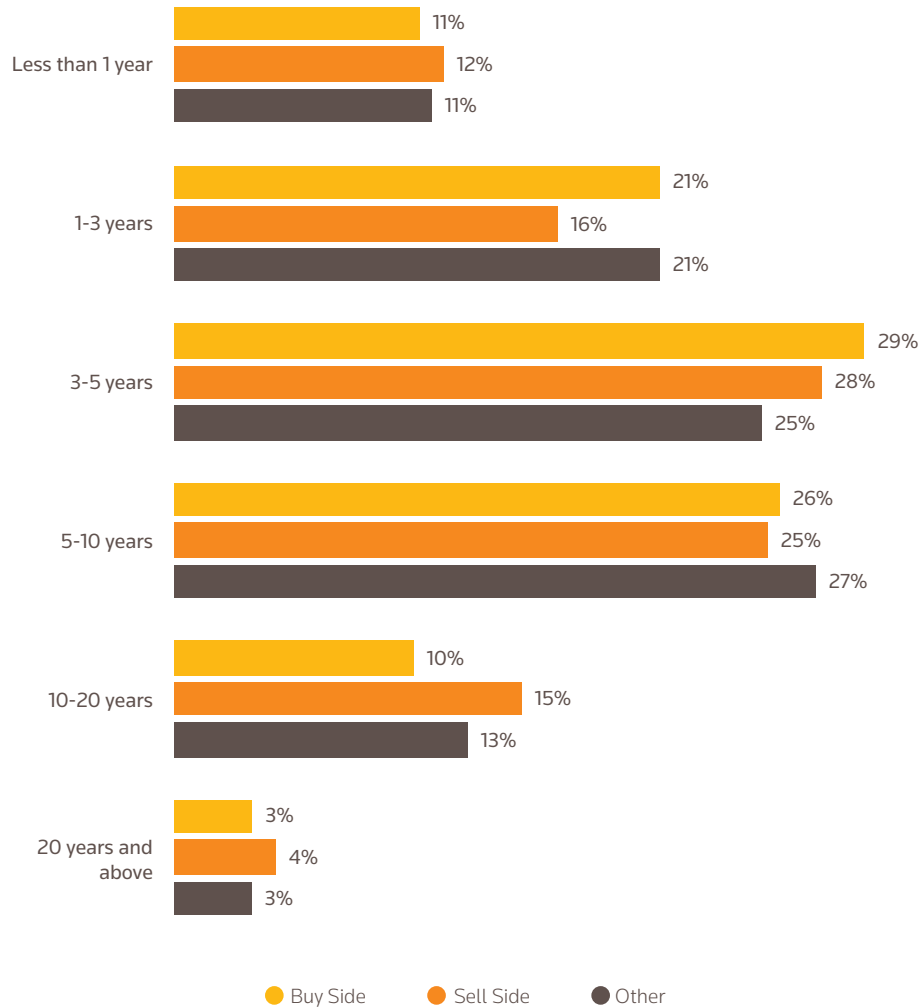
### Market preference shifts towards long-term sukuk because of lower supply

Our survey reveals that investors and issuers have a stronger preference for long-term sukuk. While most investors and issuers prefer 3-5 year tenors as last year's survey results, the second most preferred option shifted from 1-3 years to 5-10 years for investors, which matched issuers' preferences. The shift to longer tenors for investors indicates that they are willing to accept the risks associated with longer tenors in part because of the limited supply of sukuk in the market compared to previous years.

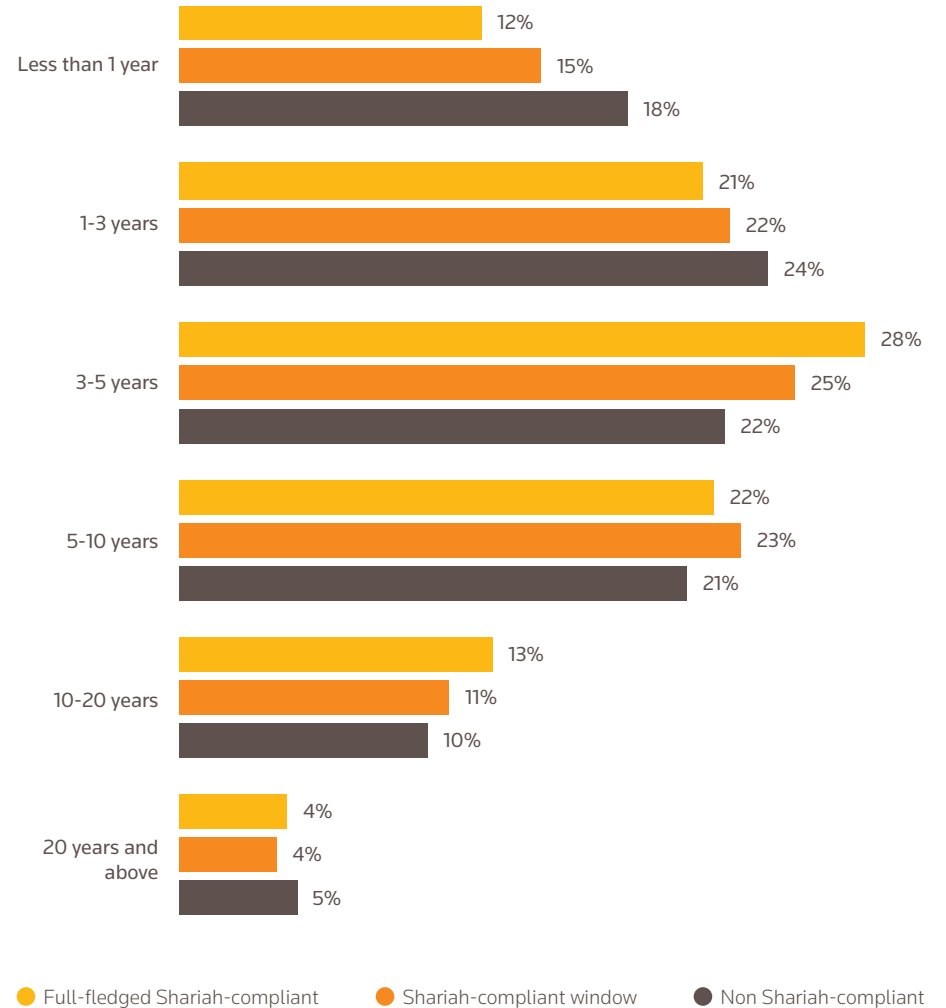
For issuers, capital spending on projects such as infrastructure with long term funding requirements, along with investors' appetite for sukuk, explains the preference for longer tenors. GCC issuers could diversify their funding sources and use sukuk with such tenors, especially given with weakening bank liquidity and the low interest rate environment. The 5-10 year period also matches the tenors for Islamic banks' Basel III capital requirement issuances. Full-fledged Islamic institutions and Shariah-compliant windows prefer 3-5 year tenors, while non-Shariah-compliant parties prefer shorter tenors of 1-3 years as they can shift more easily to conventional measures.



### SURVEY FINDINGS – TENOR PREFERENCE



### TENOR PREFERENCE BY SHARIAH MANDATE



## Average Holding Period

### Investors prefer medium-term sukuk, met with lack of supply

75% of buy side respondents say that they hold their sukuk investments for 1-5 years (medium-term), with more than 40% choosing a period of 3-5 years, and over 30% opting for 1-3 years.

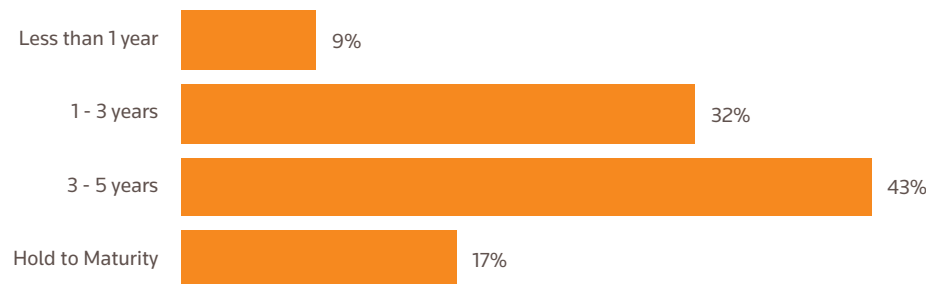
Only 9% of respondents prefer to hold sukuk for less than 1 year, mainly because of the lack of supply of sukuk with tenors of less than a year, after BNM's decision to cut short-term issuances. This is confirmed by the maturity profile of outstanding sukuk at the end of Q3 2016, where sukuk maturing within the next year account for only 10% of the total outstanding. In addition, investors in longer-term sukuk face potential reinvestment risk if they hold them for less than one year.

Investors in long-term sukuk (with tenors of over 5 years) are less likely to hold them to maturity, with only 17% of respondents preferring to do so. As the majority of recent issuances have been for tenors of 5 years and more, sukuk maturing in 5 years or more make up 48% of outstanding sukuk. As investors prefer tenors of 3 to 5 years, those investing in tradable long-term sukuk are unlikely to hold them to maturity.

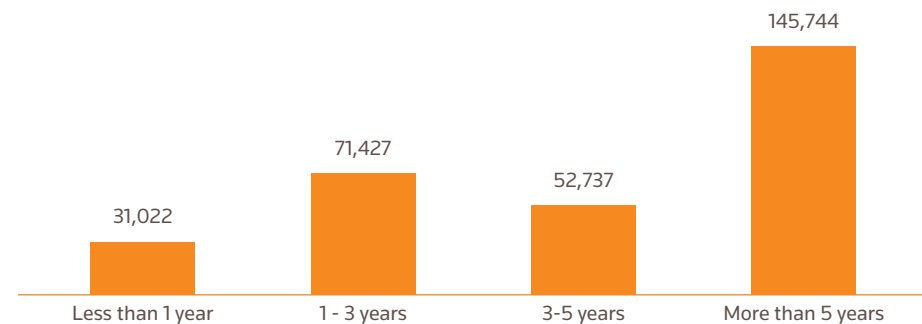
Looking at the maturity profile for outstanding sukuk as at Q3 2016, it is evident that the supply of sukuk in the global market is not in line with the preferred investment horizons on the demand side. Sukuk maturing in 5 years or longer, account for the largest share at US\$145.7 billion (48%). By contrast, sukuk maturing in 3 to 5 years, the currently preferred holding period, account for only an 18% share, or US\$52.7 billion. Interestingly, sukuk maturing in 1 to 3 years have the second largest share (24%), and sukuk maturing in less than a year have the smallest share (10%), in line with investor preferences.

With expectations of further hikes in the Fed rate, and consequently increases in interest rates in core markets (mainly GCC), investors would prefer to capitalize on potentially rising yields. This provides investors with the incentive to maintain a shorter holding period, allowing them to reinvest at higher yields. With a reduction in long-term sukuk trading on the secondary market, investors could miss out on opportunities to sell these in favor of reinvesting at higher yields in the short to medium term.

### SURVEY FINDINGS – IF YOU INVEST IN SUKUK, WHAT IS YOUR AVERAGE HOLDING PERIOD FOR THE SUKUK YOU BUY?



### SUKUK MATURITY PROFILE AS AT Q3 2016 (US\$ MILLION)



Source: Thomson Reuters



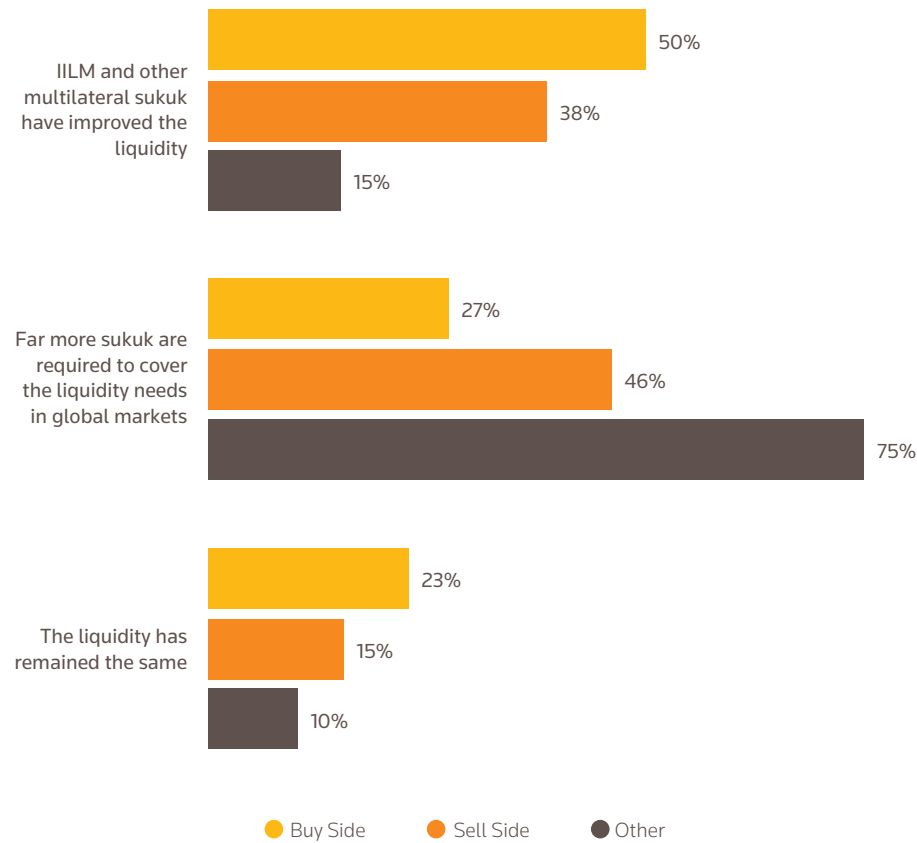
## Liquidity and Tradability

### New issuances struggling to maintain liquidity in international secondary markets

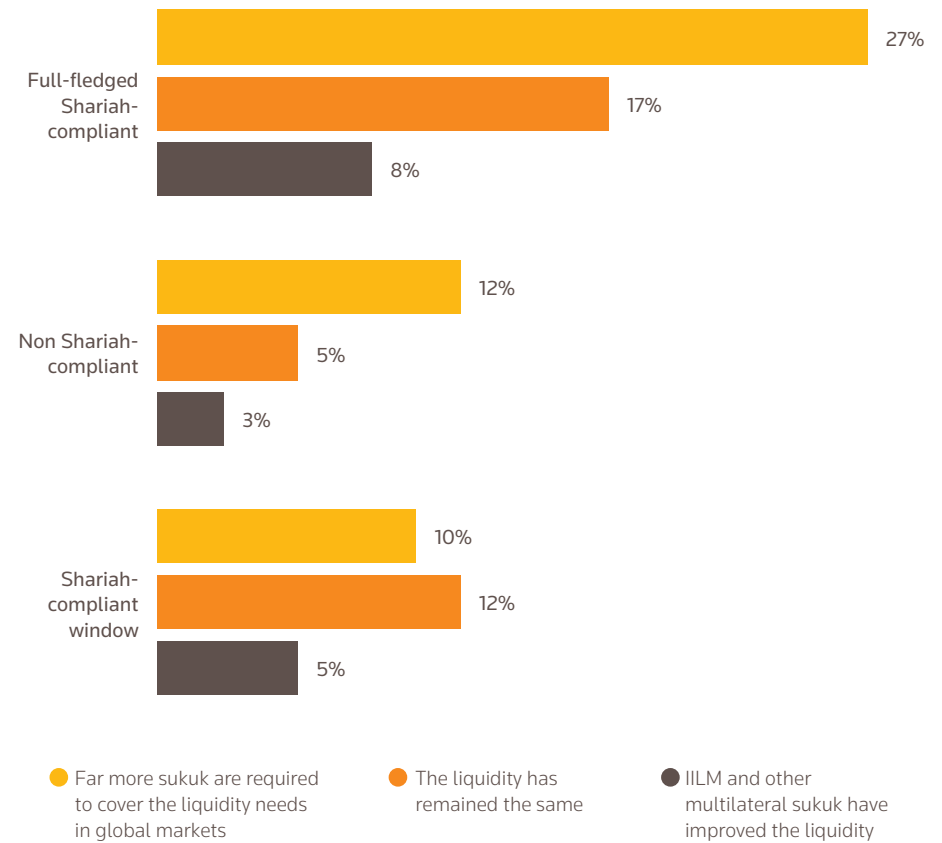
Although 50% of buy-side survey respondents expressed that they have not observed a change in liquidity in the international secondary sukuk market, most of the sell-side and other respondents say that more sukuk are required to cover liquidity needs in the global sukuk market. Both full-fledged Shariah-compliant and conventional institutions support the latter opinion.

New short-term issuances from the Far East, the GCC and Africa, in addition to institutions such as the International Islamic Liquidity Management Corporation (IILM), have introduced much needed liquidity to the secondary market through short-term issuances. However, the supply of sukuk in this market remains limited, due to the significant drop in sukuk issued in Malaysia, the largest market, following its central bank's decision to cut short-term issuances. As a result, the current supply of sukuk is still insufficient to meet investors' liquidity demands. This has also resulted in a number of these sukuk to trade at a premium because of increasing demand from investors.

SURVEY FINDINGS – ARE NEW SUKUK ISSUANCES PROVIDING ENOUGH LIQUIDITY TO COVER THE CUTBACK IN SHORT-TERM SOVEREIGN MALAYSIAN SUKUK?



BY SHARIAH MANDATE – ARE NEW SUKUK ISSUANCES PROVIDING ENOUGH LIQUIDITY TO COVER THE CUTBACK IN SHORT-TERM SOVEREIGN MALAYSIAN SUKUK?





A view of Malaysia's Public Bank headquarters in the heart of Malaysia's capital of Kuala Lumpur. REUTERS/BAZUKI MUHAMMAD

### Liquidity in Malaysia's secondary market buoyed by corporate and long-term issuances

The majority of respondents across all categories agree that liquidity in Malaysia's secondary market has somewhat been affected following BNM cutting short-term sovereign issuances. The resulting significant drop in sukuk issuance and market liquidity has been partially offset by increasing corporate issues in the Malaysian market; which overtook sovereign sukuk by number of issuances and accounted for 20% of total issuances by end of Q3 2016.

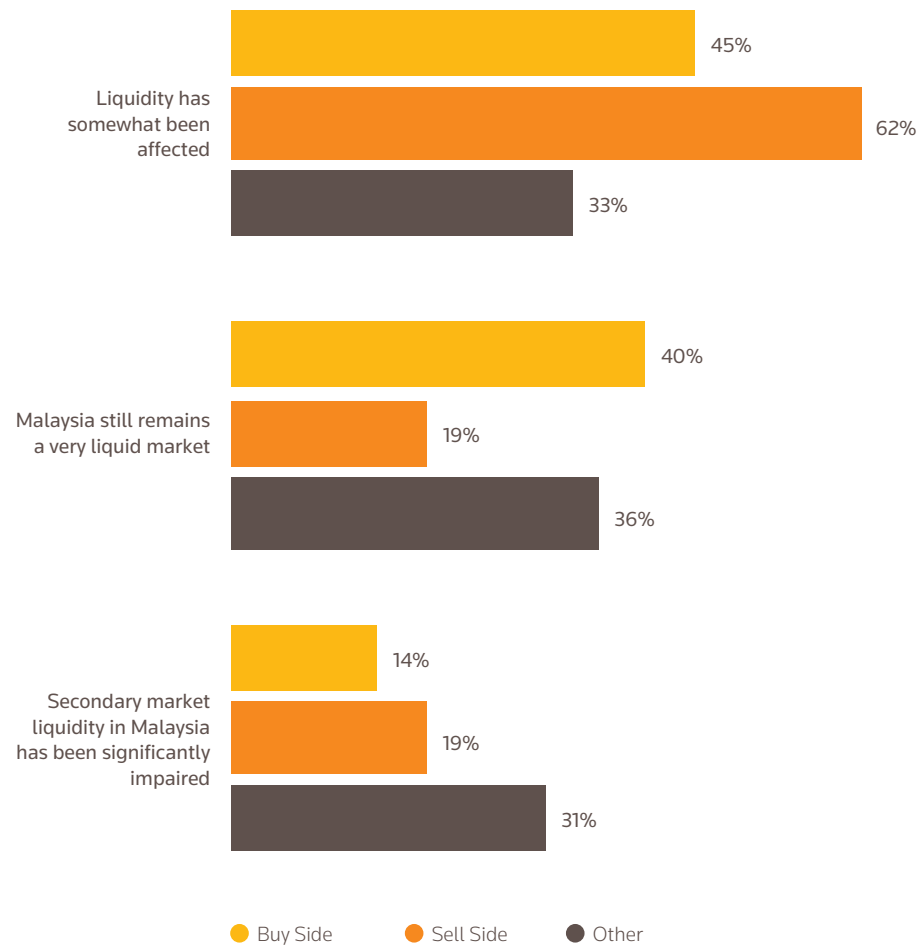
International Malaysian sovereign and quasi-sovereign issuances of over one year tenor have also increased from US\$8.1 billion in 2014 to US\$14.3 billion in 2015, and they are aimed at funding infrastructure projects and the budget deficit — maintaining liquidity in the medium-term and long-term segments of the sukuk market.

Moreover, a recent trend has emerged in the sukuk market; the issuance of Basel III-compliant sukuk. GCC banks have led this trend since 2012 and have been successful. Now, banks in Malaysia are following in their footsteps, with banks such as Amlslamic Bank issuing tier 2 capital sukuk. Other Malaysian banks, such as Bank Mumalat, are planning to issue similar sukuk, potentially boosting liquidity in the local market.

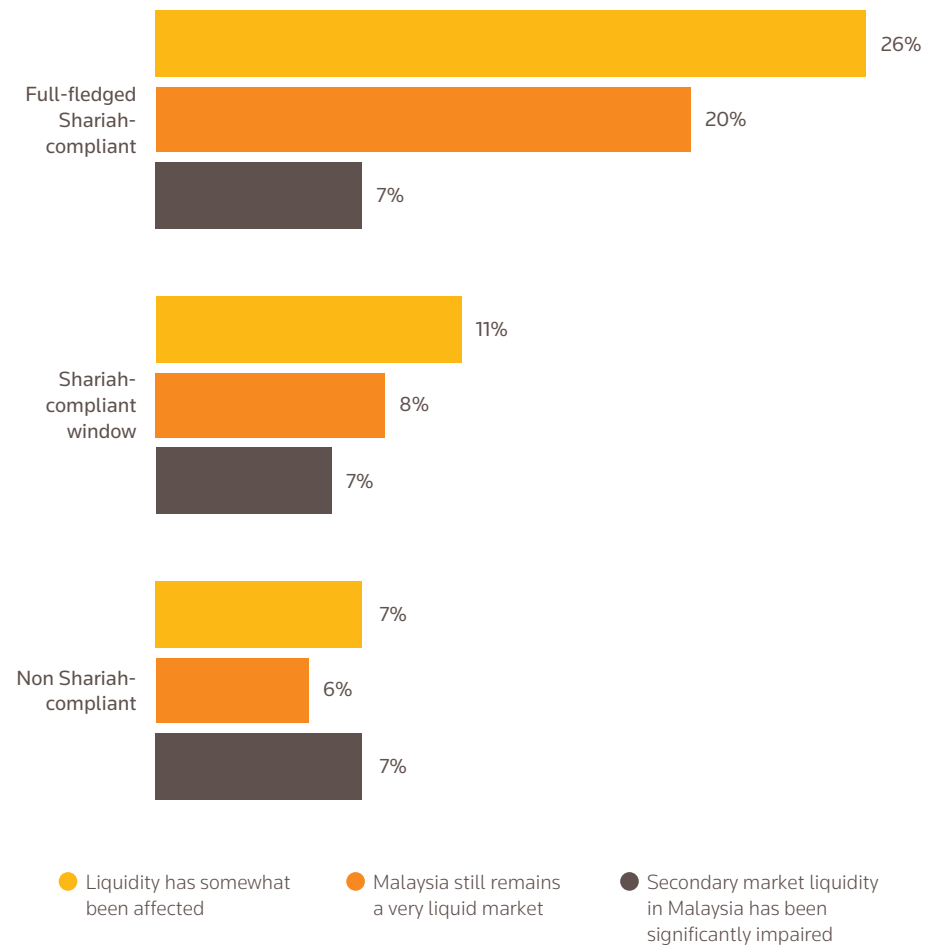
In terms of breakdown, conventional institutions are in consensus with Shariah-compliant institutions and windows that liquidity in the Malaysia market has somewhat been affected. This indicates that conventional institutions are becoming more familiar with the sukuk market, as sukuk becomes a more important and mainstream investment option.



SURVEY FINDINGS – HOW MUCH DID MALAYSIA CEASING SHORT TERM SOVEREIGN SUKUK ISSUANCE AFFECT THE LIQUIDITY IN MALAYSIA’S SUKUK SECONDARY MARKETS?



BY SHARIAH MANDATE – HOW MUCH DID MALAYSIA CEASING SHORT TERM SOVEREIGN SUKUK ISSUANCE AFFECT THE LIQUIDITY IN MALAYSIA’S SUKUK SECONDARY MARKETS?



● Liquidity has somewhat been affected    
 ● Malaysia still remains a very liquid market    
 ● Secondary market liquidity in Malaysia has been significantly impaired

## By Sukuk Bid-Ask Price Spread

### Improved bid-ask performance for different sukuk globally; negative yield hit in Luxembourg

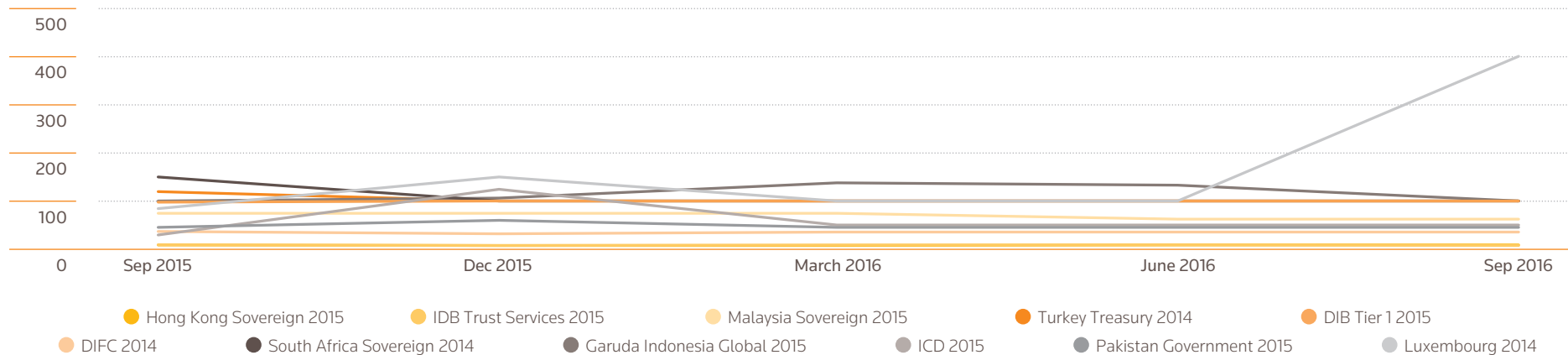
Per Thomson Reuters Eikon data, the liquidity of the sukuk market varies in line with the bid-ask price spreads for different sukuk issued in different markets. Some sovereigns like Malaysia, South Africa and Turkey with outstanding international sukuk that had bid-ask spreads over 50bps in 2014 and 2015 have seen them tighten by September 2016. This indicates improved market conditions in these countries.

International sukuk with narrow spreads (below 50 bps) have generally maintained the same low spread in this timeframe. This includes the IDB Trust certificate under its MTN program, which received high ratings from different agencies, given strong shareholder support from different governments. With low spreads, it comes as no

surprise that IDB plans to continue tapping the sukuk market to finance different projects by issuing at least a US\$1 billion sukuk each year. It also intends to increase its MTN program ceiling to US\$25 billion. Hong Kong sovereign sukuk also have high ratings with low spreads. Although Hong Kong is closely tied with China politically, economically and financially, its fiscal and foreign exchange buffers provide underlying strength and stability compared to the mainland.

Conversely, Luxembourg's sovereign sukuk spread jumped to 400 bps in September 2016 after from 80-150 bps in previous quarters. This reflects the impact of negative yields and quantitative easing on European government markets' liquidity. On Sep 30, 2016, the ask yield for Luxembourg sukuk was 0.8%, while the bid yield was 0.51%. Such a low yield decreased the appeal for investors to buy and holders to sell.

### BID-ASK SPREAD FOR SELECTED EUROSUKUK OUTSTANDING (SEP 2015 – SEP 2016, BPS)



\* Using bid and ask prices

Source: Thomson Reuters

## CHAPTER 5

# Survey Methodology

Workers suspended on ropes clean the glass windows of a building in Doha. REUTERS/JACKY NAEGELEN

## Population and Sampling

The Sukuk Forecast and Perceptions Survey 2016 involves responses from three separate groups of market players: lead arrangers/issuers, investors/traders, and other key market players such as central banks, regulators, legal advisors, and credit rating agencies.

### Lead Arrangers

In collating the population of lead arrangers, level of activity in the sukuk market was the major consideration. A total population of 50 lead arrangers was targeted based on the sukuk league table as compiled by the Zawya Sukuk Monitor, in addition to Thomson Reuters data.

The 50 arrangers were selectively chosen as a target population to represent not only the regular arrangers who usually arrange 5 to 7 international sukuk per year, but also to represent a wider range of arrangers that are continuously involved in arranging local currency issuances. This ensures a more representative sample.

### Investors

In determining the target population of investors their level of activity was considered. We chose investors across the full spectrum of sectors, with activity in sukuk investment within the last 2 years.

A target population of 200 investment firms and investor representatives was extracted from Zawya Sukuk Monitor.

### Other Key Market Players

In collecting the population of other key market players, level of involvement in the sukuk market was considered whether as regulators, legal and Shariah advisors or credit rating agencies.

A target population of 100 other key market players was extracted from Zawya Sukuk Monitor.

Returned responses for arrangers, investors and other key market players include data that some would consider being proprietary information related to the objectives of the institutions represented by respondents. The survey has also elicited responses that reveal methods of analysis and perceptions of sukuk characteristics that are expected to influence demand and supply in the market.

The response rates for both lead arrangers/issuers, investors/traders and other key market players are sufficiently significant for this exercise. We believe that the respondents' perceptions and forecasts about sukuk have provided an indicative and representative cross sample of the sukuk industry as a whole.

## Data Collection and Survey Period

The participants were first contacted via telephone to request their participation in the survey prior to sending invitations via email. Email invitations for the survey were sent on Aug 2, 2016 and reminders were sent to non-respondents on Aug 24, 2016. The survey was closed at 23.59 GMT on Aug 25, 2016.

## Survey Questions

3 types of questions were presented to the target population — multiple choice questions, ranking questions, and open-ended questions.

For ranking questions, the data was analyzed such that most points were awarded to the first choice, least points to on the last choice and corresponding points for the choice in between. The weighted average results are represented in the charts.

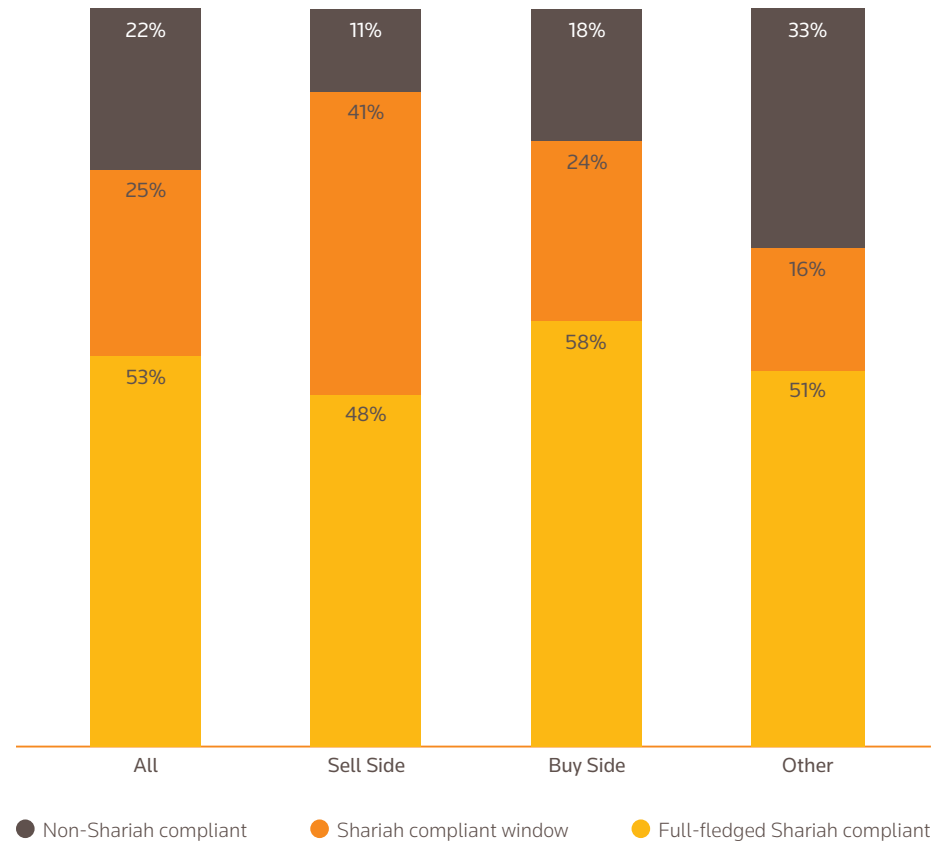
## Ex-post analysis

The Sukuk Forecast and Perceptions Survey has three separate group of participants: buy side which consists of investors and traders, sell side which consists of lead arrangers or issuers and other key market players such as regulators, legal advisors and rating agencies. The survey received response from 120 market players. Buy side is the largest group with 50 respondents followed by other market players (43 respondents) then sell side (27 respondents). Full-fledged Shariah-compliant institutions constitute the majority of respondents.

By company’s regional base, the majority of the survey respondents are based in Middle East and North Africa Region followed by Europe and Central Asia. This is applied to all groups of participants.

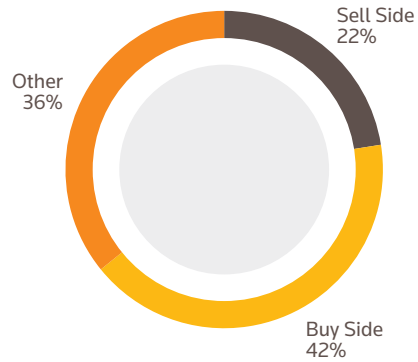
By sector distribution, Islamic banks take the lead for all parties whether from buy side or sell side.

### TYPE OF INSTITUTION

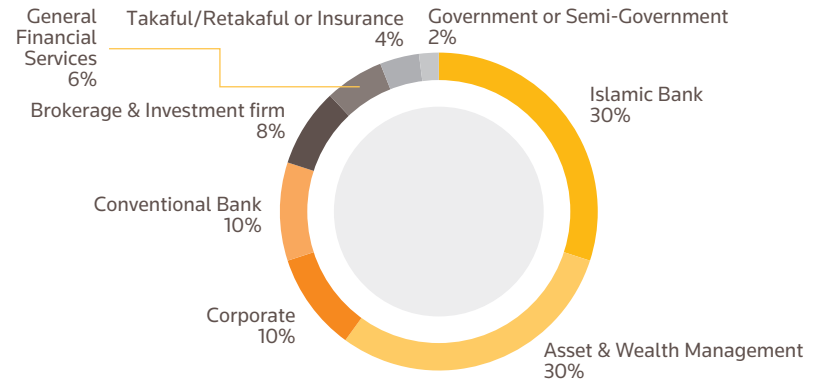




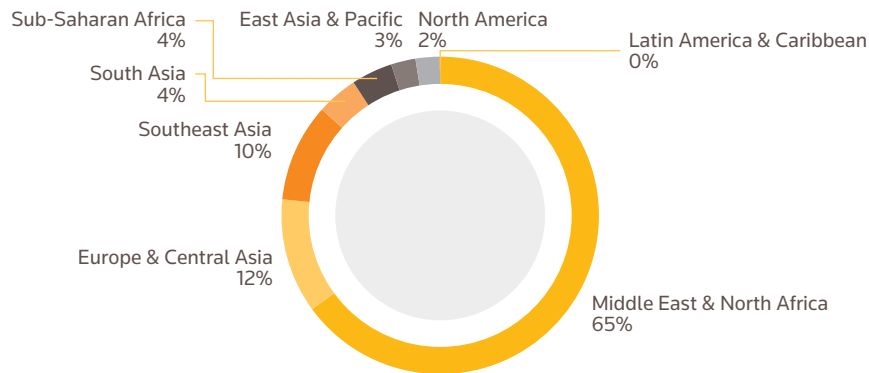
### PRIMARY ROLE IN SUKUK MARKET



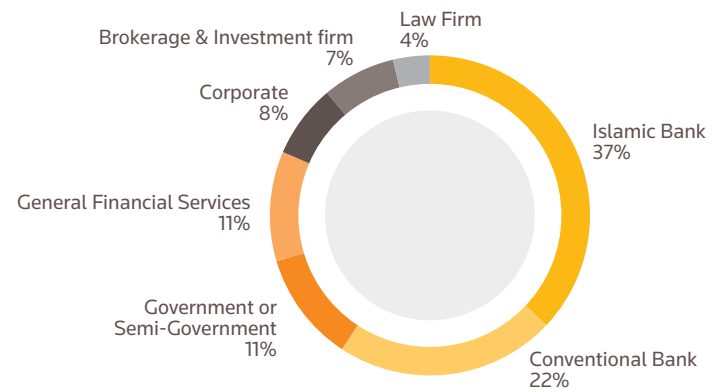
### BUY SIDE – TYPE OF SECTOR



### COMPANY'S REGIONAL BASE



### SELL SIDE – TYPE OF SECTOR



## Sukuk Study Authors

### Report Authors



**Redha Al Ansari**

Project and Team Leader  
Capital Markets and Market Intelligence



**Jinan Al Taitoon**

Senior Research Analyst



**Shereen Mohamed**

Research Analyst



**Blake Goud**

IFG Contributor

### Report Consultants



**Mustafa Adil**

Head of Islamic Finance



**Ammar Radhi**

Senior Proposition Manager



**Shaima Hasan**

Research & Bespoke Solutions Manager

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SUKUK PERCEPTIONS & FORECAST STUDY 2017

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