An Introduction to Islamic capital markets

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Objectives

What do we want to achieve in this session?

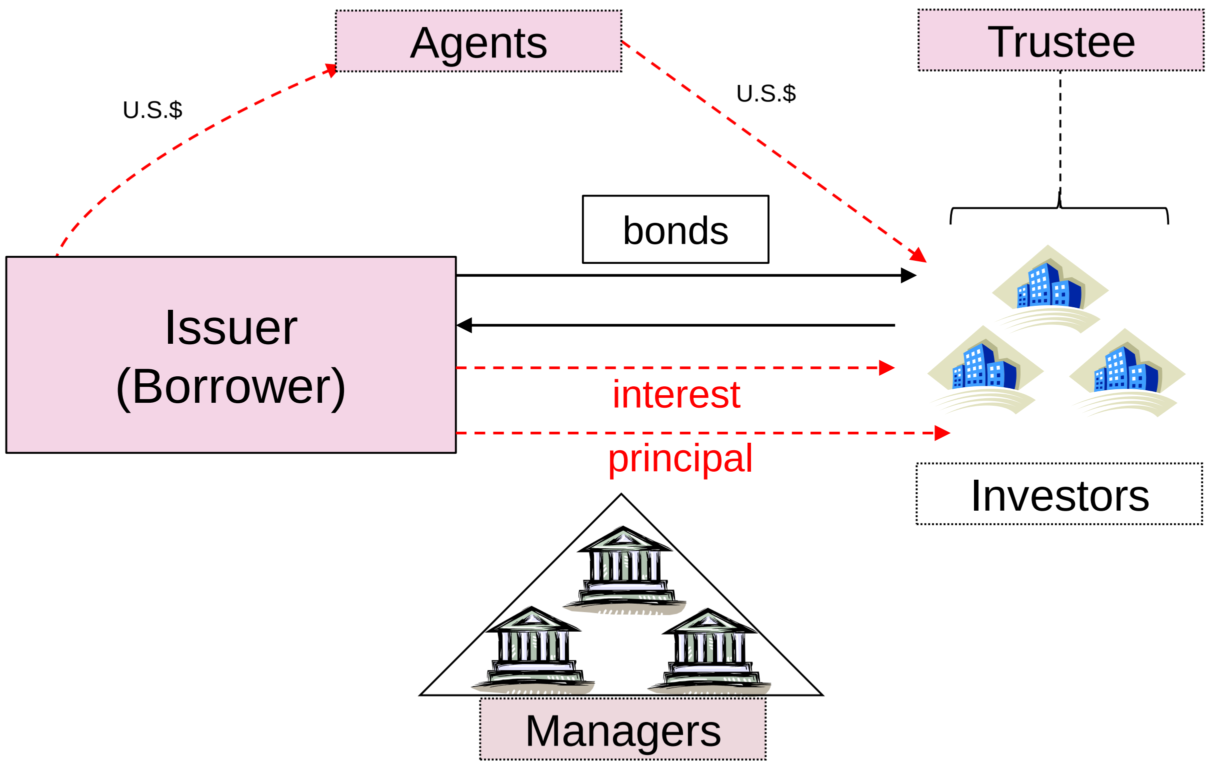
- What are the capital markets?
- What are the Islamic capital markets?
- Understand *sukuk* and how they differ to conventional bonds.
- Identify the main *sukuk structures* and understand the *ijara*
- Understand current market *trends* for sukuk

What are the capital markets?

- Common ways a company raises funds:
  - issue shares
  - borrow money
- Common ways a company borrows money:
  - bank market (loan)
  - issue debt securities
- Capital markets are markets for buying and selling equity securities (i.e. shares) and debt securities (i.e. bonds).
- Capital markets include primary markets, where new stock and bond issues are sold to investors, and secondary markets, where existing securities are traded
- Key participants: buyers, sellers and financial intermediaries
- Purpose of capital markets is to match demand for funds with supply of funds – fuels economic growth

What are bonds?

A bond is conventional debt security – an instrument issued by a borrower under which the borrower promises to pay to the holder the amount borrowed plus interest at the end of a given period



What are the Islamic capital markets?

- Any market in which Sharia'a compliant securities are traded.
- Includes Sharia'a compliant stock and/or sukuk markets.
- Companies and governments use the Islamic Capital markets to raise funds for their operations or expand ongoing activities e.g.
  - a company may undertake an IPO
  - a government may issue Sharia'a compliant securities or Sukuk to raise funding for public projects
- Role of Investors - purchase Sharia'a compliant securities in order to extract a return and earn profit on the securities.
- Markets in Muslim States - such as Bursa Malaysia (leading market by volume) and Saudi Arabia (Tadawul) and UAE (Dubai, Abu Dhabi and Nasdaq Dubai) becoming increasingly important and will increase as they develop
- Major international primary markets - IPOs and Sukuk may be placed with investors through underwriters, and secondary markets, where all subsequent trading takes place, such as the London Stock Exchange, Irish & Luxembourg stock exchanges – not just a Muslim world phenomena

Islamic capital market: a component of the Islamic financial market

The Islamic financial market

Islamic Banking & Takaful

Islamic banking Financial Products

- Sharia'a deposit investment products
- Money market products
- Financing products
- Other Investment products

Takaful Investment Products

- Takaful products
- Takaful linked investment products

Islamic Interbank Money Market

Islamic Capital Market

Equity

- Sharia'a compliant securities
- Islamic indexes
- Islamic Unit Trust
- Islamic venture capital / PE
- Islamic ETF
- Islamic Fund Management
- Islamic REITs
- Islamic Structured Products
- Islamic stock broking

Sukuk

- *ijara*
- *istisna'a*
- *musharaka*
- *murabaha*
- *wakala*
- *mudaraba*

Sharia'a-compliant derivatives

Exchange traded
- Futures
- Single Stock Futures (provided the underlying shares are Sharia'a-compliant)

OTC
- Islamic profit rate swap
- Foreign Exchange swap
- Cross Currency Swap

What are *Sukuk?*

- "Islamic bond": Sharia-compliant equivalent of a conventional bond
- equity investment vs. debt instrument
- certificates of equal value representing undivided shares in ownership of an underlying asset (including tangible assets, usufructs, services and/or other contractual rights).
- Origins of sukuk
- not simply a claim to cash flow but an ownership claim in a pool of assets → differentiates sukuk from conventional bonds as the latter represents a debt due under an interest-bearing security
- Sukuk mirror the economic effect of conventional bonds
- can be issued in tradeable form and listed on usual stock exchanges

Sukuk in a nutshell

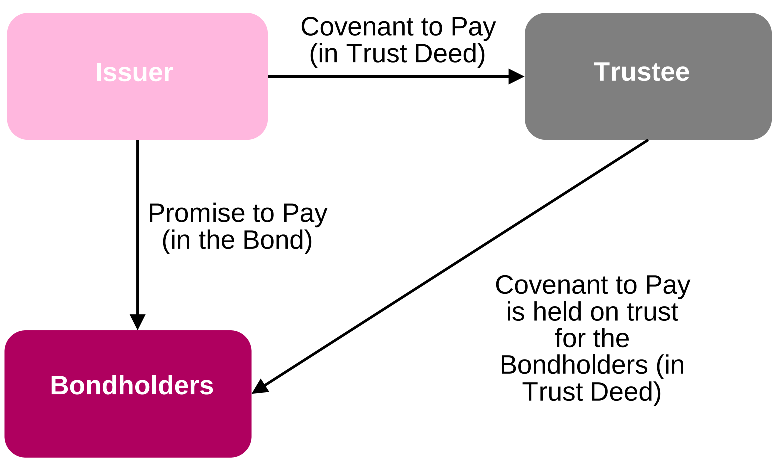
- Basic structure: Issuer issues Sukuk and collects proceeds from Sukuk Investors and uses those proceeds to acquire the Islamic asset(s) on behalf of Sukuk Investors. The Issuer then declares a trust over these proceeds and assets.
- Underlying asset: the underlying asset is another Islamic contract e.g. *ijara* or *mudaraba* hence the reference to *sukuk al-ijara etc*
- Basis of entitlement: The commercial exploitation of underlying assets generates return for Sukuk Investors. *Sukuk*holders are entitled to receive their share of profits generated by the asset and the proceeds of disposal of the asset at the end of the term.
- Redemption mechanisms: Typically most Sukuk are redeemed by the eventual sale of the underlying asset to the Originator. In a default, Sukuk Investors have the right to enforce a buy back agreement with the originator. (Legal documentation does not typically give Sukuk Investors powers to take over the underlying asset and dispose them).

Differences between sukuk and conventional bonds

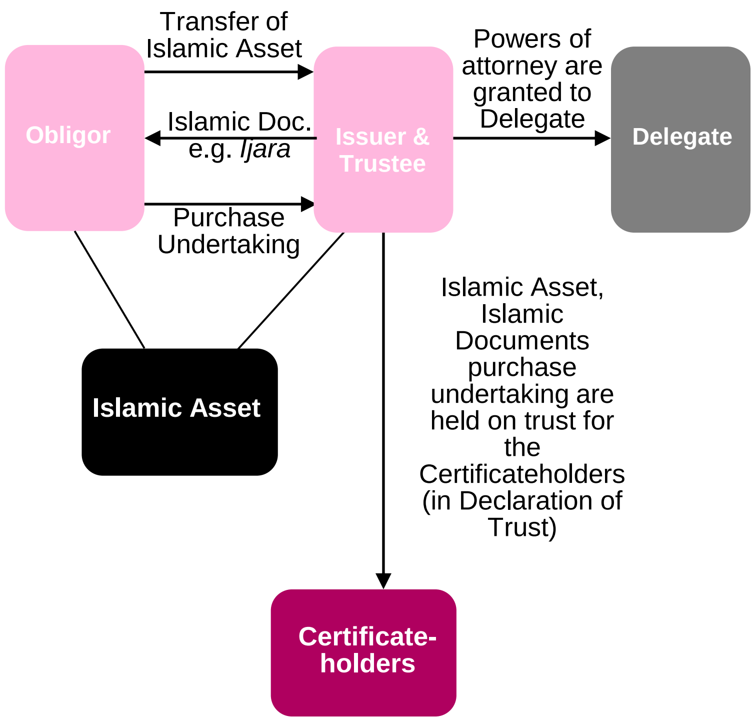
Parameter	Sukuk	Conventional interest bearing instrument
Issuer	A Sukuk issuer has to be engaged in Sharia'a compliant business activities	An issuer of conventional bonds is not limited in its business activities
Investor base	Enjoys a wider investor base from both Islamic and conventional investors	Conventional bonds can mainly tap conventional investors
Ownership	Investors take ownership of an underlying asset or pool of assets	A conventional bond represents the financial obligation (debt) of the issuer
Administrative costs	May incur additional legal fees and Sharia'a advisory fees	No additional administrative costs associated with a conventional issue
Financing costs	The increased investor pool can create larger demand and help achieve more competitive pricing	A comparatively smaller pool of conventional bond investors may imply less demand for the instrument

Bond vs *Sukuk* Structure

A. “Conventional” Bond



B. Sukuk



Basic *Sukuk* Structure

CAPITAL MARKETS INSTRUMENT

UNDERLYING *SUKUK* STRUCTURE

Why use *sukuk*?

For Islamic Financial Institutions (IFI) and Corporates	Investors
• Liquidity management	• Sharia'a compliant asset class
• Fundraising	• Tradability
• Securitisation	
• Balance sheet management	

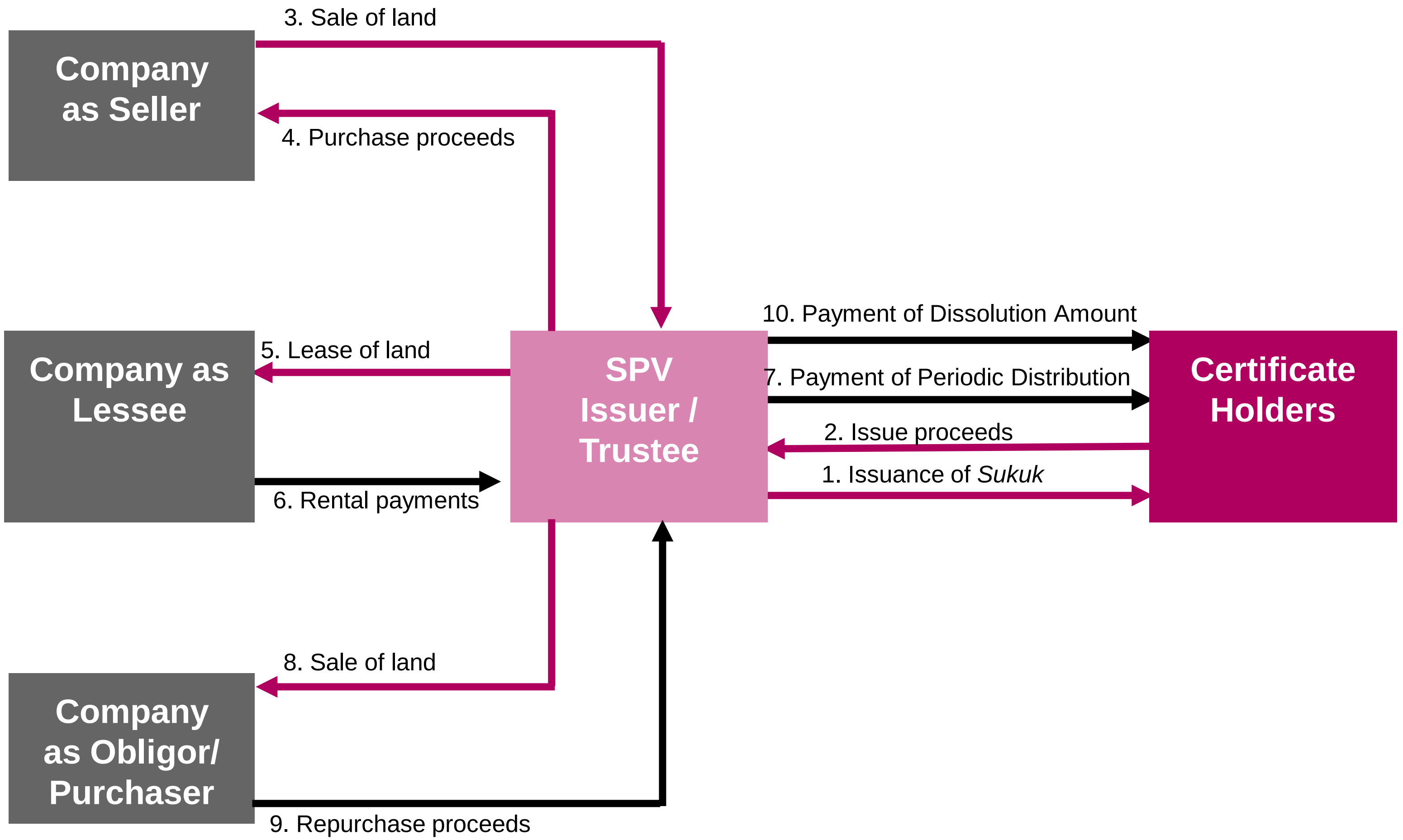
The resulting benefits of Sukuk:

- represents a new source of funds, increasingly at attractive rates
- are vital to developing deeper and more liquid Islamic capital market
- provide scope for wealth to be unlocked → there is a great deal of surplus cash sitting in IFIs waiting to be tapped by new Shariah-compliant financial instruments

Sukuk Structure Building Blocks

- *Ijara* (lease)
- *Mudaraba* (investment manager/profit-sharing arrangement) - widely used pre-GFC, now only for perpetual issues
- *Wakala* (agency arrangement)- favoured by IFIs but finding more commercial applications
- *Murabaha* (deferred payment sale)
  - only feasible in the primary market
  - trading in the secondary market is not generally permitted by Shariah as the certificate represents a debt owed by the obligor to pay the deferred sale price
  - popular in Malaysian market where the sale of debt (*bay al dayn*) at a negotiated price is permitted
- *Istisna'a* (construction contract – common in project financings)
- *Musharaka* (joint venture)
- Hybrid/pooled sukuk – used to create "asset-lite" structures

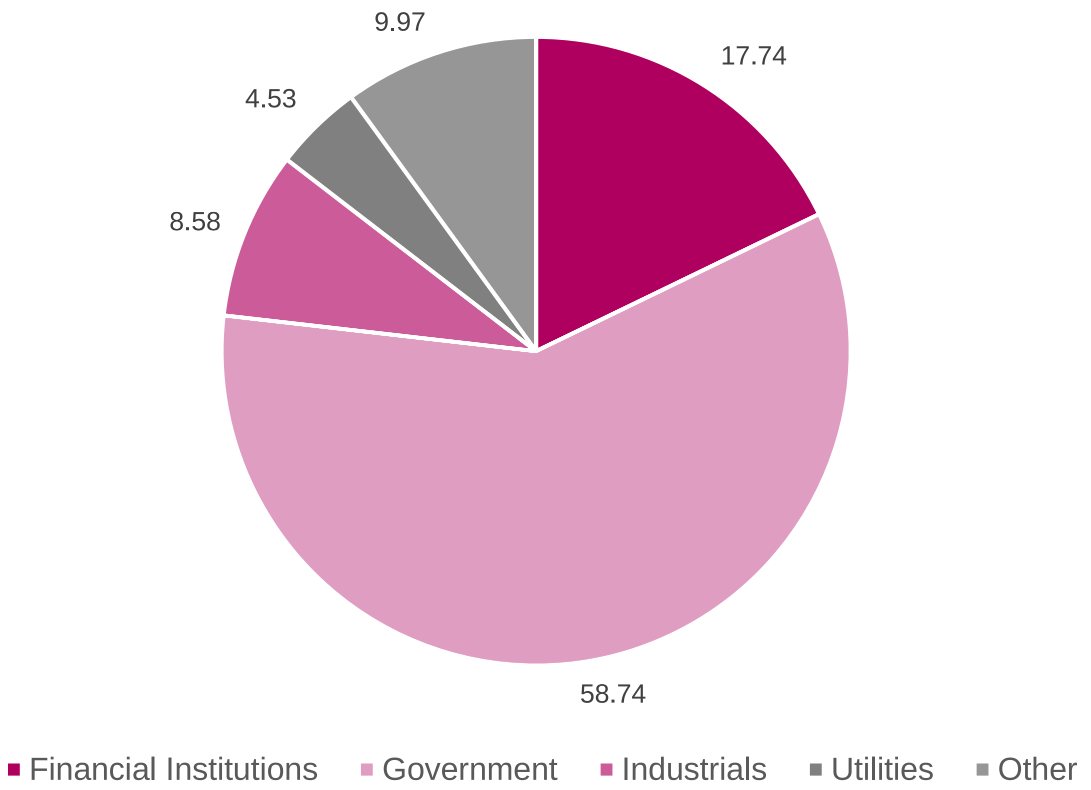
Sukuk al-ijara structure



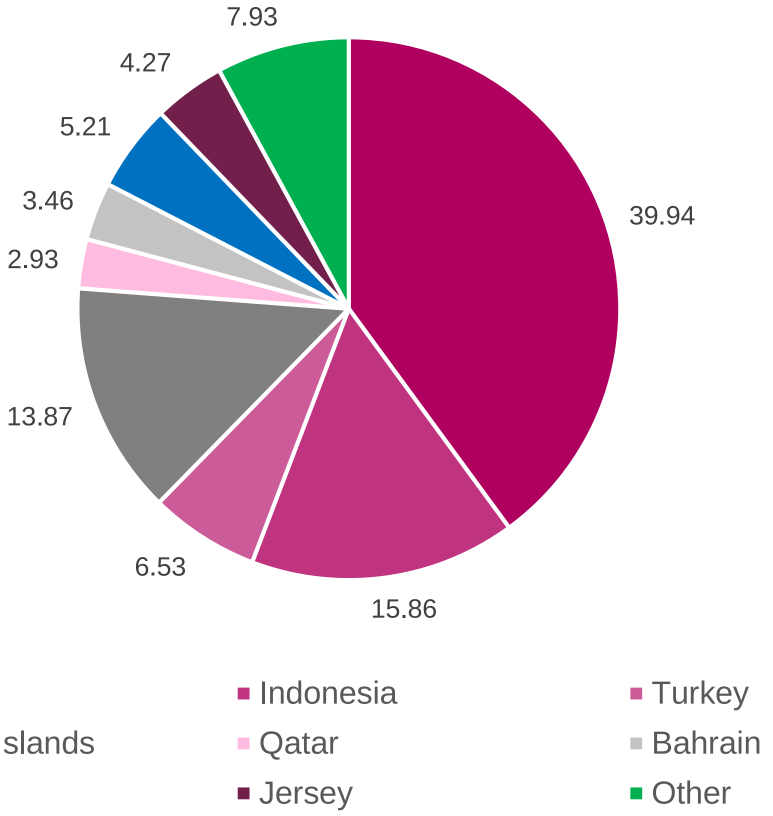
Market and trends

- Global market size 2016: U.S$40.3 bn (deal value), 135 issues
- Significant increase in global sukuk issues since mid-2011
- Sukuk pricing has become cheaper as demand has increased
- Move towards hybrid structures
- Changing nature of assets underpinning sukuk, capacity-based sukuk – airtime, ATKMs, concession rights
- Sukuk more widely used by broader range of issuers: sovereigns, telecoms companies, airlines
- Sovereign issuers (Oman, Qatar, Hong Kong, Pakistan, Bahrain, Dubai, UK, Luxembourg)
- 59% of *sukuk* issued in 2016 was by governmental institutions
- Dominance of Malaysia and Malaysia Ringgit
- Significant innovation in last 10 years- market has seen: project finance sukuk, amortising sukuk, export-credit agency based sukuk, regulatory capital sukuk

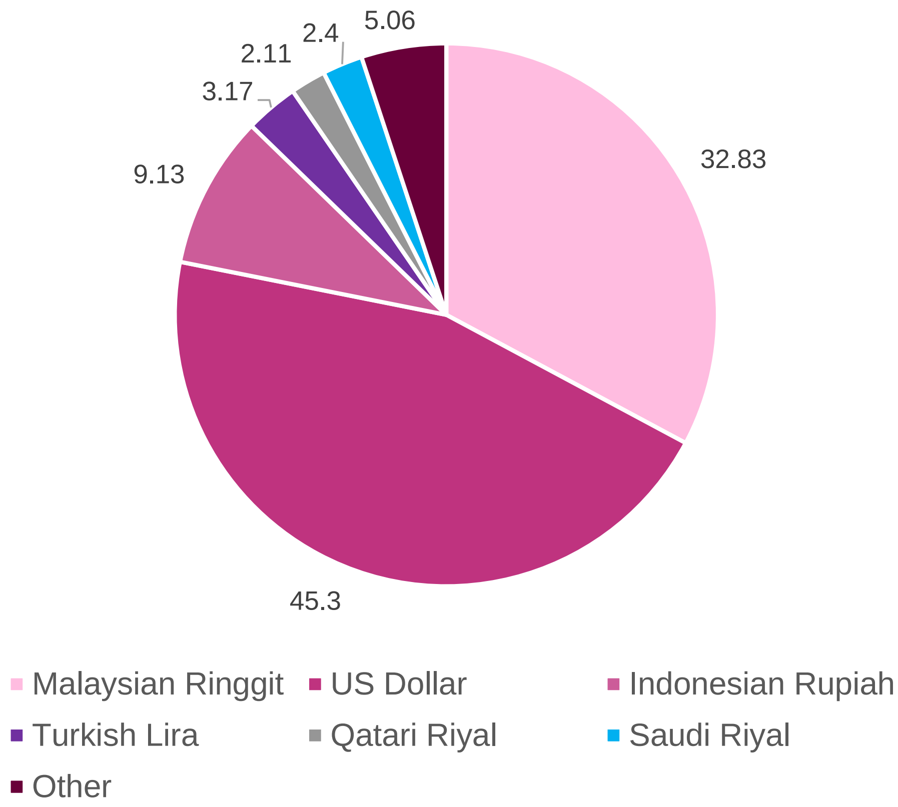
Trends – Global *Sukuk* Issues 2016 by sector (Bloomberg)



Trends – Global *Sukuk* Issues 2016 by country (Bloomberg)



Trends – Global *Sukuk* Issues 2016 by currency (Bloomberg)



Any Questions?