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 sukuks and how they differ to conventional bonds.
- Identify the main sukuks structures and understand the ijara.
- Understand current market trends for sukuks.
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 Capital Market**
- **Equity**
  - Sharia’a compliant securities
  - Islamic indexes
  - Islamic Unit Trust
  - Islamic venture capital / PE
  - Islamic ETF

- **Sukuk**
  - *ijara*
  - *istisna’a*
  - *musharaka*

- **Sharia’a-compliant derivatives**
  - Islamic Fund Management
  - Islamic REITs
  - Islamic Structured Products
  - Islamic stock broking

- **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

**Islamic Interbank Money Market**
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

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

A. “Conventional” Bond

- **Issuer**
  - Promise to Pay (in the Bond)
  - Covenant to Pay (in Trust Deed)

- **Trustee**
  - Covenant to Pay is held on trust for the Bondholders (in Trust Deed)

- **Bondholders**

B. *Sukuk*

- **Obligor**
  - Islamic Doc. e.g. *Ijara*
  - Purchase Undertaking

- **Issuer & Trustee**
  - Transfer of Islamic Asset

- **Delegate**
  - Powers of attorney are granted to Delegate
  - Islamic Asset, Islamic Documents purchase undertaking are held on trust for the Certificateholders (in Declaration of Trust)

- **Islamic Asset**
  - Certificateholders
Basic Sukuk Structure

CAPITAL MARKETS INSTRUMENT

UNDERLYING Sukuk STRUCTURE
Why use sukuk?

For Islamic Financial Institutions (IFI) and Corporates

• Liquidity management
• Fundraising
• Securitisation
• Balance sheet management

Investors

• Sharia’a compliant asset class
• Tradability

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

1. Issuance of Sukuk
2. Issue proceeds
3. Sale of land
4. Purchase proceeds
5. Lease of land
6. Rental payments
7. Payment of Periodic Distribution
8. Sale of land
9. Repurchase proceeds
10. Payment of Dissolution Amount

Company as Seller → SPV Issuer / Trustee
Company as Lessee → SPV Issuer / Trustee
Company as Obligor/ Purchaser → SPV Issuer / Trustee
Certificate Holders → SPV Issuer / Trustee
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?