The World Bank Group

Government Bond Market Advisory Services Peer Group Dialogue

Meeting #14: Minutes

Sukuk as Instruments for Government Funding and Development

Date:	June 3, 2014
Place:	Conference call led by the WB/Government Bond Market Advisory Services Team in DC. Supported by GoToMeeting conference tool.
Time:	8:00 am- 9:30 am (EST time)
Attendees:	Country Participants: • **Brazil:** Márcia Tapajós, Adonias da Costa, Roberto Beier (Brazilian Treasury) • **Egypt**: Noran Youssef (Ministry of Finance) • **Hungary:** Laszlo Buzas, Anita Marosvölgyi, János Horváth, Judit Orbán Orelné (Government Debt Management Agency) • **Kenya:** Racheal Njoroge, Livingstone Bumbe, Stella Osoro, Robert Osudi, Felister Kivisi, Charles Kairu, Bernard Gibet (Ministry of Finance) • **Malaysia:** Kamilah Mohamad, Azizul Sabri Abdullah (Central Bank of Malaysia) • **Morocco:** Soumaya Sabounji, Mustapha Ait Lhaimair (Ministry of Economy and Finance) • **Pakistan:** Athar Ghafoor, Muhammad Farrukh, Muhammad Ali Malik, Amin Lodhi, Muhammad Kashif Rahim (State Bank of Pakistan) • **Peru:** José Olivares, Guadalupe Pizarro, Óscar Pinedo, Frank Henríquez, Carmen Zuzunaga, Carlos Evangelista, Ariel Vargas (Ministry of Economy and Finance) • **Romania:** Mihaela Demetriuc, Alexandra Tudoran, Cristina Mitru (Ministry of Public Finance of Romania) • **Saudi Arabia:** Maha Al-Rashudi, Saleh Alyahyan, Wisam Alfreihi, Eamonn AlMutaw, Abdallah Abdulmalik A. Alshaikh (Capital Market Authority) • **South Africa:** Phumzile Maseko, Isabelle Kaira (National Treasury) • **Turkey:** Fatih Bozkurt, Alper Koparan, Murat Cobanoglu, Kursad Arslan (Turkish Treasury) • **Uruguay:** Victoria Buscio, Rodrigo Sarachaga (Ministry of Economy and Finance) World Bank Group Participants (staff and consultants): • Anderson Silva, Ketut Ariadi Kusuma, Indhu Raghavan, Tamuna Loladze, Alison Harwood, Honglin Li, Raymond Sabbah, Timothy J. Brennan, Zauresh Kezheneva, Eva Hansen

	Other Participants: • Michael J.T. McMillen (Presenter, Curtis, Mallet-Prevost, Colt & Mosle LLP) • Ibrahim Mardam-Bey (Presenter), Beatriz Ariza, Ismail Tazi (Taylor-DeJongh) • Khalid AlSaeed (IMF)
Topic:	Sukuk as Instruments for Government Funding and Development
Objectives:	• Introduction of the topic by the World Bank • Presentations of the topic by two private sector experts • Insights from country experiences • Discussion and Q&A
Issues discussed:	**Sukuk as source of capital** • The **structure of sukuk** is similar to conventional asset-backed securities. Sukuk are suitable for "hard" assets and at times non-hard assets that can be defined legally as assets. • Sukuk can be **classified as debt or equity**; they are securitizations of either pools of assets or are whole business securitizations. • For sovereign entities, sukuk have been used for **project financing,** e.g. natural resource or infrastructure activities such as airports. • Sukuk are both issued **domestically and internationally**. Domestic issuances continue to dominate, but international issuances are increasing. • **Ability to attract liquidity** from investors in the Middle East and South East Asia is one of the main reasons for increased interest in sukuk issuance. Higher savings in these regions have increased demand for Islamic structured savings products. • **Cost of capital has improved** in the sukuk industry making sukuk highly competitive. Sovereign or large corporate issuers no longer pay a significant sukuk premium. • The sukuk industry broadly **withstood the financial crisis** and the structure seemed to withstand pressure as well as conventional instruments. **The sukuk market today** • By 2013, the global sukuk market **exceeded USD 120 billion**. • **Malaysia is a leading market** in terms of volume of sukuk issuances, and Malaysian sukuk markets are the most mature and sophisticated. • **Other countries** with sovereign sukuk markets include Saudi Arabia and Bahrain, while western countries looking to issue sukuk include Luxemburg and UK. • Currently demand for sukuk is higher than supply with an estimated **demand/supply gap of over USD 200 billion** in annual sukuk issuance. • **Complexity of the underlying laws** is one of the reasons that issuance

is muted on the sovereign side resulting in excess demand.

The investor base for sukuk

- **The potential investor base** for sukuk is broad and includes essentially the same types of investors as for regular government instruments namely retail investors, non-bank financial institutions, pension funds, etc.
- Some of the potential investors are **specific to Islamic structured products,** such as Islamic financial institutions and Takaful (Islamic insurance) companies.
- **The largest growth in demand** is expected to be in the Takaful market, as well as from pension funds and endowment funds that are looking for well-structured fixed yield type instruments that are sharia compliant.
- At the moment**, investors are predominantly located** around the main capital markets in Gulf Cooperation Council (GCC) countries and in mature Asian markets (mainly Malaysia).
- **USA and UK insurance companies** are also significant purchasers. These investors look to buy a government credit that match fund the obligations they manage (long term), whereas they are typically indifferent to whether the investment is sharia compliant or not.
- For sovereign issuances, **issuer rating** is important for investor interest as many institutional investors can only purchase rated obligations (either due to law/regulation or internal policies).

Sukuk issuance

- **The first steps** for a government to consider include 1) determining the size of issuance, the purpose of raising the money, and use of proceeds; 2) deciding between domestic and international issuance; 3) having an issuing bank or advisor to assist in the process.

Domestic vs. international issuance

- **Reasons for increased international issuance** include: Difficulties with domestic regulatory standards, market saturation, risk diversification, tax issues, foreign ownership requirements, and other bottlenecks.
- Related to the decision on international issuance is also the decision on **currency matters** tied to handling of proceeds from the issuance.

Underlying assets and sukuk structures

- **Starting the asset determination process early** is crucial as it usually takes time to identify a suitable underlying asset.
- **The market determines the sukuk structure and vice versa** – some sukuk structures cannot be sold in certain jurisdictions.
- **Al-Ijara (lease structure)** is accepted in all jurisdictions and historically the Ijara has been the predominant sukuk structure. The reason partly being that secular laws have dealt with lease structures for many years (sharia compliant lease structures are quite similar to conventional lease structures). From a legal point of view the law for these issuances is very

well developed.

- **The use of Wakala (agency structure)** has increased, largely due to these structures being accepted globally.
- **Examples of assets** used for government sukuk issuances are real estate, computer equipment, medical equipment of state-owned hospitals, etc.

Legal issues for consideration when issuing

- Often **the securitization structure already in place** in a country can be used to begin issuance of sukuk without developing new legislation.
- For al-Ijara obligations, **there are usually many restrictions legally** on the ability of governments and government-owned entities to sell, repurchase, place lease on, or ring-fence property. Most sukuk – including lease sukuk – are sales for sharia purposes.
- **Competitive bidding requirements** in relation to transactions pose a problem when the issuer is securitizing an asset that will eventually be bought back (e.g. if a government would like to lease a building into a trust or special purpose vehicle (SPV) and issue sukuk on the trust/SPV).
- **The structure of the sukuk and asset determination is critical** for planning the issuance given potential legal restrictions, e.g. to foreign ownership or in real estate laws.
- **Foreign ownership restrictions** will often have to be removed if the sukuk will be sold or traded internationally, as the sukuk is a fractional undivided ownership of the underlying assets in the pool or company.
- Other legal issues include the **taxation of sales and repurchases** (as the issuers get back the asset at the end of transactions).
- **If the asset allow for offshore issuance**, international issuances are often done through tax free jurisdictions, which greatly limit potential tax issues. Offshore issuance can also be done to avoid the time-consuming process of setting up the SPV. Use of lease-lease back transactions rather than transfer of asset may be used to address the issue of governments not being able to sell or not wishing to transfer assets internationally (may also be used domestically if the asset cannot legally be sold).

Two types of issuers

- **1) Trusts** are used by Anglo-American jurisdictions and by Civil Law countries that either duplicate the trusts (as trusts are not recognized under Civil Law) or pass the trust laws (e.g. Bahrain). The UN has a program on trust laws directed at importing trust laws into Civil Law jurisdictions.
- **2) Corporate SPVs** are frequently used, particularly for international transactions. These are more difficult and more costly to use than trusts, as it is necessary to import all fiduciary obligations into the SPV (these come automatically in a trust if the country has a trust law; some fiduciary obligations are then excluded).

Secondary market

	• The secondary market for sukuk is **developing quickly** but from a **small base.** • One of the **reasons for this lack of secondary market activity is the gap in the supply,** meaning that may investors effectively buy sukuk and hold them instead of buying sukuk for trade. **<u>Compliance with international regulation</u>** • Increasingly there is a **question as to whether sukuk qualifies as Tier 1 capital under Basel III**. There are some non-redeemable, non-cumulative, preferred types of issuances that qualify. • **The demand for Tier 1 compliant issuances is high**, as several Islamic banks have difficulties filling their Tier 1 capital requirements with sharia complaint instruments. **<u>Country experiences</u>** *Malaysia* • **The main purpose** of sukuk issuance is to meet the funding requirement of the government. **Other key drivers** for sukuk issuance include 1) meeting demand from Islamic players in the domestic market, 2) developing the Islamic financial markets, and 3) broadening the investor base. • Except for the difference in terms of the underlying assets supporting sukuk issuance, the **process for sukuk issuance largely follows the same process as for conventional bonds**. A separate issuance calendar for sukuk is published, and domestic issuance is through auctions with same obligations for primary dealers as for conventional bonds. • **Sukuk issued domestically** follow sharia contracts accepted by the domestic market and using the concept of Murabaha (commodity asset). For these issuances, the government does not need to identify a specific asset for the issuance as long as a sufficient number of sharia suitable commodities are traded on the exchange for the government to use to support the issuance. • **International sukuk issuances follow** the sharia concepts recognized by the global investor community. International issuances have historically followed the structure of Ijara, but are now moving towards a greater use of Wakala (which requires less of the tangible asset to back a given amount issued). No differences have been experienced between Ijara and Wakala issuances in terms of demand, yield, and secondary market trade. The largest challenge in international issuance is to identify a suitable asset given the market and sharia contract to be used. • **Malaysia experiences a challenge related to investor education** with respect to the difference between asset-based and asset-backed issuance. *Turkey* • **The main drivers for initiating sukuk issuance** were 1) to reach Middle Eastern and Asian investors; and 2) to establish good practices and open the way for private issuers (some already issuing

internationally).

- **Turkey started issuing sukuk in 2012** and has until now issued four times in the domestic market in Turkish Lira and two times internationally in US dollars.
- **Sukuk issuance is regulated** under an article in the Public Finance and Debt Management Law.
- **All issuances have been structured as al-Ijara**, but there are plans to issue sukuk under other structures such as Murabaha and CPI-linked sukuk.
- **For the purpose of al-Ijara issuance, an SPV has been established** (fully owned by the Treasury) to which ownership of public real estate assets have been transferred. The SPV sells lease certificates to investors and the proceeds are transferred to the Treasury in return for the asset transfer. The public institutions continue to use the assets that have been taken over by the SPV as the assets are leased back to the Treasury with the Treasury paying periodic lease payments (which are transferred to the investors by the SPV). At maturity, the assets will be purchased by the Treasury and the proceeds of the sale are transferred to the sukuk holders.
- **Strategies to increase secondary market trade** volumes for lease certificates are being developed. In 2013, the trading volume amounted to approximately 800 million Turkish Lira, which is estimated to be below potential.

Egypt

- **A Sukuk law was promulgated in 2013**, but due to political unrest, Egypt has not yet issued sukuk.
- **To develop the sukuk market**, authorities provide the relevant legal framework, market infrastructure, and build human capacity. The strategy is to build benchmarks and a sukuk curve; leading eventually to allow the private sector to issue sukuk.
- **Egypt has separate government and corporate sukuk laws** due to differences in accounting methods and market supervisory authorities. Egyptian law follows an asset-based model allowing only beneficial right on privately-owned assets (publicly-owned assets cannot be used as underlying assets).
- The government sukuk law **permits issuance based on all kinds of sharia contracts** and an asset valuation committee shall evaluate privately-owned assets such as lands, roads, buildings, etc. that can be used as underlying assets.
- Egypt has a **sovereign central SPV** for all government issuances, as well as a **sovereign central sharia committee** that shall approve all sukuk issuances.
- **There is big demand from local Islamic banks** for short term sukuk for asset-liability management.

<u>**Corporate issuance**</u>

- **Legal issues are more complicated** for corporate issuances than for

	sovereign. • **Corporate issuers are** usually private companies that either 1) have tapped out local lines of credit with banks, leaving securitization of assets as the only alternative; or 2) companies seeking to establish a track record in issuing paper (e.g. due to preparation of an IPO or an acquisition) and to establish an independent access to capital.
Documents discussed:	• Presentation on "Islamic Finance: An Alternative Source of Capital" provided by Mr. Ibrahim Mardam-Bey.
Next steps:	• Solicit other topics for discussion in future PGD meetings.