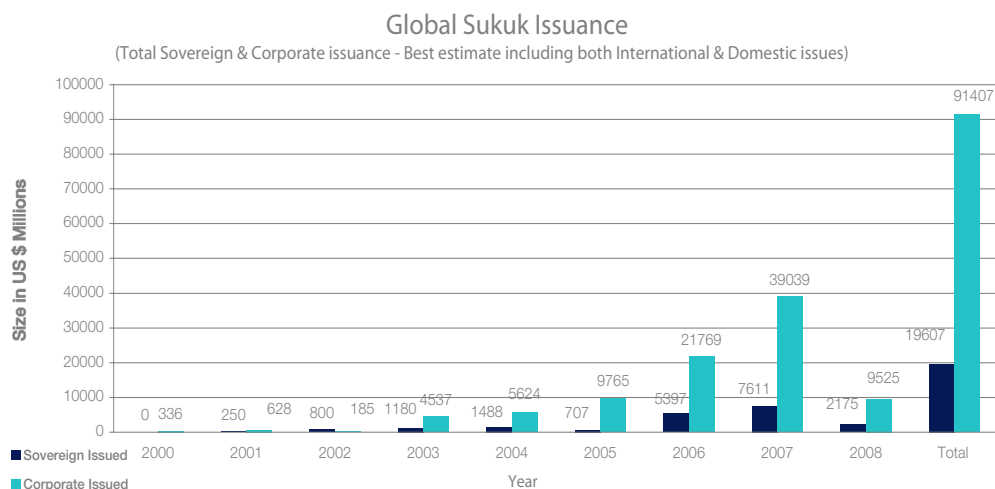
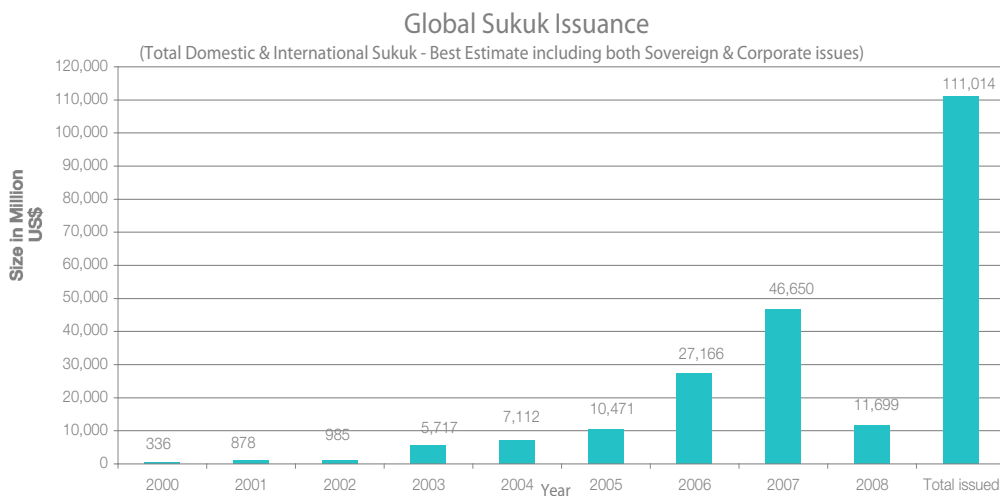


Capacity Building Needs for Issuing Sovereign Sukuk

Global Sukuk Market

Sukuk started as a recognized Islamic financial instrument about nine years ago. The \$100m Bahrain sovereign issue in 2001, and two Malaysian international issues, the \$600m Sovereign benchmark and Guthrie \$150m corporate issues in 2001-2002, led the global Sukuk market development. As shown below, total issues through June 2008, including Malaysian domestic, exceeded \$111 billion.



IIFM Analysis

It can be seen that whilst Sovereign issues have not shown any significant growth, International Corporate issues have been growing annually at about 150% through 2005 and 400+% by December 2006.

Salient Features

Listing - Corporate issues are generally listed on local rather than international exchanges, with the two largest being listed on the DIFX. There are some exceptions, such as the Tabreed and Wings Issues, which have been listed on either Luxembourg or London. However, nearly all the Sovereign issues have been listed on Luxembourg, and many are dual-listed regionally on LFX, DIFX or Bahrain SE.

Maturities - These range from three months (Bahrain Salam Sukuk) to ten years, with the average being around four to five.

Price basis - Of the issues analyzed (20% of data), 50% were floating and the other half were fixed in some way. However, nearly all the Sovereign issues, except most of those in Bahrain, have been floating. If the Bahrain fixed issues are excluded, the percentage of fixed issues falls nearer to 40%. Of the total 17 benchmark issues, only 29% were fixed-rate; even less, 10%, of the Sovereign benchmark issues were fixed-rate. This is in stark contrast to the conventional market, where 95% of all issues are fixed-rate.

Sukuk compared to Conventional

The distinction between the Malaysian and mainstream Islamic approaches is germane to an analysis of the distinctive nature of Sukuk when compared with traditional fixed-income instruments. The Islamic preference for asset-backed financing and risk-sharing mechanisms creates built-in safeguards that protect both institutions and investors. In an Islamic finance culture, there is a strong aversion to high levels of debt, interest and speculations. This essentially implies financial prudence and encourages a greater asset orientation, which some may

consider being collateralized, and transaction-delimited risk sharing Sukuk as an innovative Islamic product may be structured and issued to achieve exactly these qualities. But first, how do Sukuk stand up to conventional fixed-income products?

Ijlal Alvi

“The Sovereign Sukuk are enjoying widespread and positive acclaim among Islamic investors.”



Landmark Sovereign Sukuk

Since the Bahrain and Malaysia sovereign Sukuk issuances, members of the Organization of the Islamic Conference (OIC) countries have become increasingly active issuers in the international markets. The Sovereign Sukuk are enjoying widespread and positive acclaim among Islamic investors and global institutional investors, which are not traditionally active with Islamic structures or in Islamic regional markets.

On the one hand, many of the OIC countries and their agencies are asset-rich and cash-poor. Therefore, Sovereign Sukuk are an ideal method to monetize existing assets. On the other hand, OIC countries fall into two very different tax regimes. The Arabian Gulf States tend to be low- or no-tax states, whereas the poorer OIC countries may have extensive, but unenforceable, tax regimes. Therefore, Sovereign Sukuk or state-sponsored Sukuk allow both groups to generate cash without raising taxes or otherwise altering their tax regimes. An additional benefit is that Sovereign Sukuk give central bankers their first tool to truly manage domestic money supply and credit extension of Islamic banks under their jurisdiction with a uniquely Islamic instrument.

However, to mid-December 2006 there have only been some 70 international issues totaling in the order of US\$ 21 billion. One third of these were Sovereign (in Europe, Sovereign issues account for more than half of all issues) and two thirds were Corporate/Institutional. Of the total 17 benchmark issues, only 29% were fixed-rate with even less, 10%, of the Sovereign benchmark issues being fixed.

This is in stark contrast to the conventional market, where 95% of all issues are fixed-rate. The reasons for this present predominance of floating rate issues appear to result primarily from the self-interest of liquidity-rich Islamic banks looking for assets, paucity of issues along with a very shallow investor base.

Outside of Malaysia, only Bahrain (and recently Brunei) has regular issues of fixed-rate short tenor (91-day) Sukuk, which could be used for bank liquidity management. Continuous government issues with regular and planned auctions are fundamental to market development, as are benchmark fixed-rate issues with a wide spread of maturities, which could be used for infrastructure funding.

The low total volume issued to date, scarcity of fixed-rate instruments and lack of a diverse investor base makes the Islamic bond market one-sided, with a predominance of buy-and-hold investors leaving the secondary markets quite inactive.

Other fundamental aspects of a developed bond market concerning issues presently missing from the Islamic market are the absence of Benchmark fixed-rate issues extending yield curves out to long maturities (even SABIC, at 20 years, was an FRN) and cost-effective hedging instruments.

Sukuk Capacity Building

Legal framework is a key part of the infrastructure. Under Shari'ah, a company owned by a natural person has to be established and then contracted to perform the required duties to become a de facto trustee. This requires restrictive covenants to represent the investor's best interests and being owned by nationals leads to questions concerning foreign control, ownership, collateral and nature of capital flows.

However, most Islamic markets are not governed by Shari'ah courts, but subject to a local version of civil code not particularly supportive of capital markets, especially in the areas of trust law and SPV structures. Specific amendments in most markets still need to be made to local code, trust law, banking and securities regulations. Some other issues are as follows:

Clearing and Settlement Systems - International Sukuk are scripless issues with a global certificate lodged with Euroclear/Clearstream, enabling orderly settlement.

A primary dealer network should be established for those houses that cannot meet Euroclear requirements.

Late Payment – This can be resolved by agreement with clearing-houses to change their penalty mechanism.

A suitably capitalized Special Purpose Company should be formed to settle any claims on behalf of Islamic institutions.

A Central Counter Party (CCP) is a financial institution that acts as an intermediary between security market participants. This reduces the amount of counterparty risk to which the market participants are exposed. CCPs must have adequate risk management systems, including sound margining policies, collateral management procedures and strong capital cushions.

Primary Market - A well-functioning primary market underpinned by government securities is fundamental to ensure orderly funding of capital market and government borrowing needs. The choice of issue procedures and distribution will depend on the stage of market development and country circumstances. Local exchanges have to be brought up to international standards and should look to establish links with other exchanges, if they are to play a role in the cross-border market. Setting up a primary dealer system will facilitate the changeover from the usage of captive internal sources of Sovereign financing to a system of market-based financing.

Investor Diversity & Education - There is no real depth or diversity to investors in the Islamic markets outside Malaysia, with financial institutions being the largest holders of Sukuk. Banks' average take is more than 75% of all issues. In the conventional market, it's around 25%.

Transparency & Disclosure - Outside Malaysia, there is relatively little depth of information, consistency or transparency. Without this information, it is difficult for market makers or investors to gain the facts they need to determine strategy or pricing. There should be consistent prospectus information and availability of primary issue information.

Market Practice - Many areas of issue structure and practice are still at odds with the developed markets, and even in advanced developing markets, such as Malaysia. These include aspects such as pricing, fixed-rate, tenors, yield curve, issue quality and rating.

Liquidity & Secondary Market - A secondary market is effectively absent for several reasons, including too few issues; some structures are not or are not always tradable; lack of experienced market makers; RAR issues, particularly on corporate bonds; and few money market instruments, including sovereign Repo facilities.

Settlement & Custody - The similarity between the way international Sukuk and conventional bonds are treated is clearly illustrated by 16 being listed on Euroclear.

Other aspects - These include a lack of professional (and independent) interdealer brokers with established, global distribution; absence of hedging instruments; relatively poor professional qualifications; other (non-bond) trading systems.

Recommendations

In order to have a truly well-developed and integrated international Sukuk market, following measures must be adopted vis-a-vis Sovereign Sukuk issuance:

- Legal and regulatory framework
- Arbitration
- Primary market
- Fixed-rate and long-term maturity
- Short-term Ijarah type Sukuk necessary for Islamic Money Market
- Settlement and custody – international and national level
- Inter-dealer brokers
- Hedging instruments
- Yield curve creation based on Sovereign Sukuks

Ijlal Alvi is the Chief Executive of IIFM since mid-2005. Mr. Alvi has two decades of extensive financial services industry experience mainly in the areas of Islamic corporate and development finance, treasury, capital markets and corporate re-organization. Prior to moving to the Gulf, he had spent 10 years at senior positions in the areas of Treasury & Capital Markets with international and regional financial institutions. Since 1997, Mr. Alvi has served at senior positions with a number of Middle East-based financial institutions.