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Sukuk Issuance Is Up And Running, But Will The Climb Continue Apace?

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Global sukuk issuance topped $13.7 billion in the first six months of 2010, nearly doubling the $7.1 billion recorded during the same period last year. In Standard & Poor's Ratings Services' view, slightly improved international market conditions supplied some of the impetus. Sovereigns accounted for the lion's share of issuance, representing about 75% of total volumes as governments strived to revive the market. At the same time, we saw some private sector issuers return to the market. Financial institutions and companies from both the Gulf Cooperation Council (GCC) countries and Asia gradually crept back to the market. We think their return will likely continue.

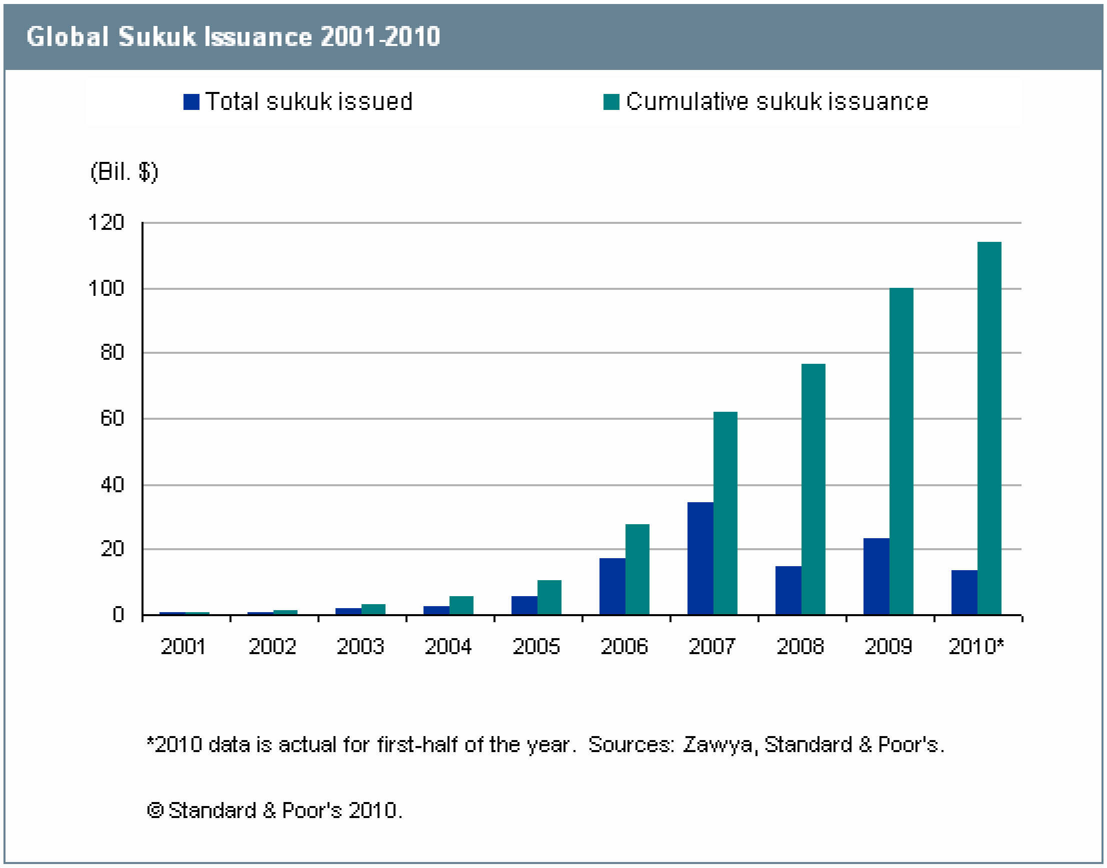
July 2010 saw Japan's first sukuk issue, sending in our view a signal that the sukuk market is continuing its march toward globalization. We believe that many issuers around the world may be willing to enter the market as more favorable conditions materialize. We foresee sustained growth for the second half of 2010, given issuers' interest in tapping this market, both in historical locations such as Asia, especially Malaysia, and in regions newer to sukuk.

Despite the sukuk market's current upturn, major questions for the market still remain unanswered, in our view. Resolving sukuk defaults, standardizing Sharia interpretation, and increasing sukuk liquidity, we believe, are at the root of issues that could curb future growth. It is the solutions to these issues--likely in our view to be neither easy nor quick--that we believe will shape the direction the market takes.

Sukuk Issuance Increased Sharply In The First Half Of 2010

Sukuk issues numbered 98 during the first six months of this year, versus 32 in first-half 2009, lifting total issuance to $13.7 billion (see chart 1). The average issue amounted to $140.8 million, compared with $222.7 million one year earlier. Governments and central banks issued a large portion of these sukuk in a move to benefit from still-available pockets of liquidity and to create local instruments for liquidity management of Islamic financial institutions.

Chart 1



The Sukuk Footprint Is Gradually Getting Bigger

Nomura Holdings added Japan to the league of sukuk issuers, issuing a $100 million Ijara sukuk in July 2010 (see Related Criteria And Research below). And in the months to come, we expect to see a rise in the number of sukuk issues from new players, such as Singapore, Thailand, and Hong Kong.

Meanwhile, with Asia continuing to predominate in first-half 2010 with 70% of total issuance, we see broadening the investor base as a key consideration for Asian companies and financial institutions entering the sukuk market. Cementing its position as the world's top sukuk market, Malaysia alone contributed 52.7% of total issuance, including its sovereign-sponsored Ijara transaction involving the sale of 12 government-owned hospitals throughout Malaysia. In addition, we note that Malaysia has funded infrastructure projects, using a sizable portion of its domestic currency issuance. Infrastructure programs are attracting considerable interest from Islamic investors because of the asset-backing nature of these projects in general.

Some of the Gulf countries are slowly re-entering the market, taking their share of total issuance to about 30% during the first half of 2010. Issues leading the way included three large sukuk issued by Saudi Electric Co. (AA-/Stable/--) for $1.8 billion, the State of Qatar (AA/Stable/A-1+) for $1.3 billion, and Dar Al Arkan (BB-/Stable/--) for $450 million. The market has also re-opened for well established issuers based in the United Arab Emirates. For instance, the National Bank of Abu Dhabi (A+/Stable/A-1) issued a $155 million sukuk on the

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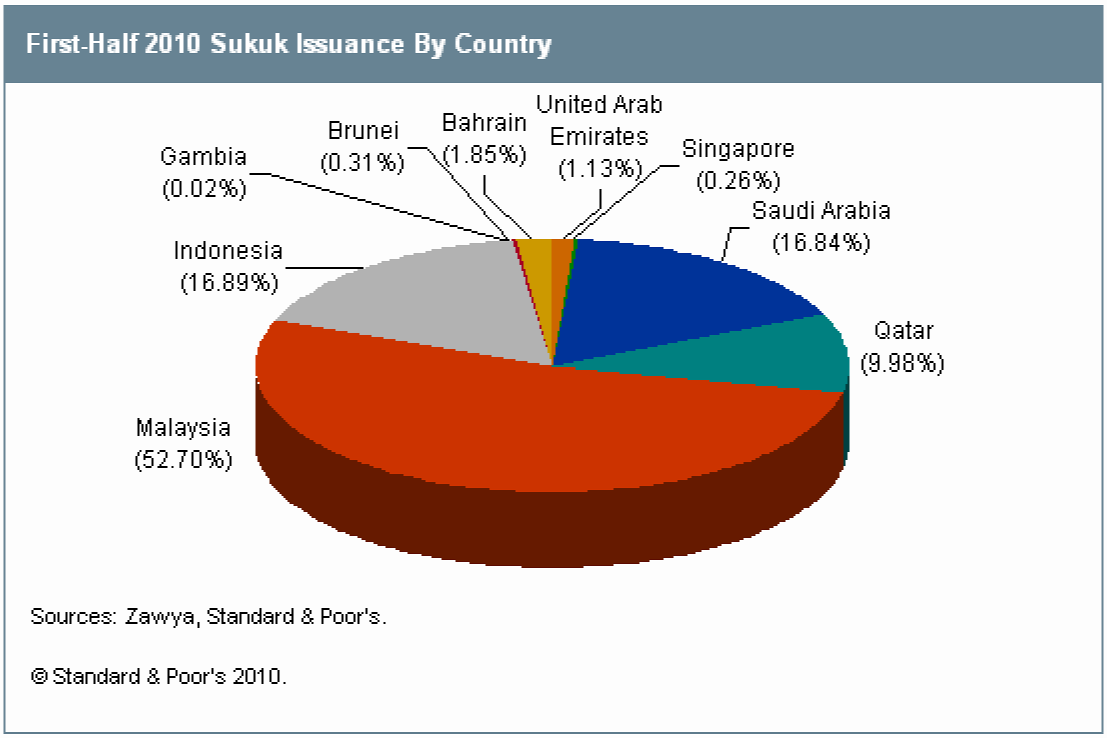
Malaysian market in June 2010.

We think that the speed with which the market broadens its geographic reach will hinge closely on market conditions. Just recently, a Russian company postponed its planned sukuk issue, citing disadvantageous international market conditions. At the time of writing, we estimate that about 150 sukuk are either already in the starting blocks or warming up on the sidelines. We expect that these will likely come to the market as and when conditions allow.

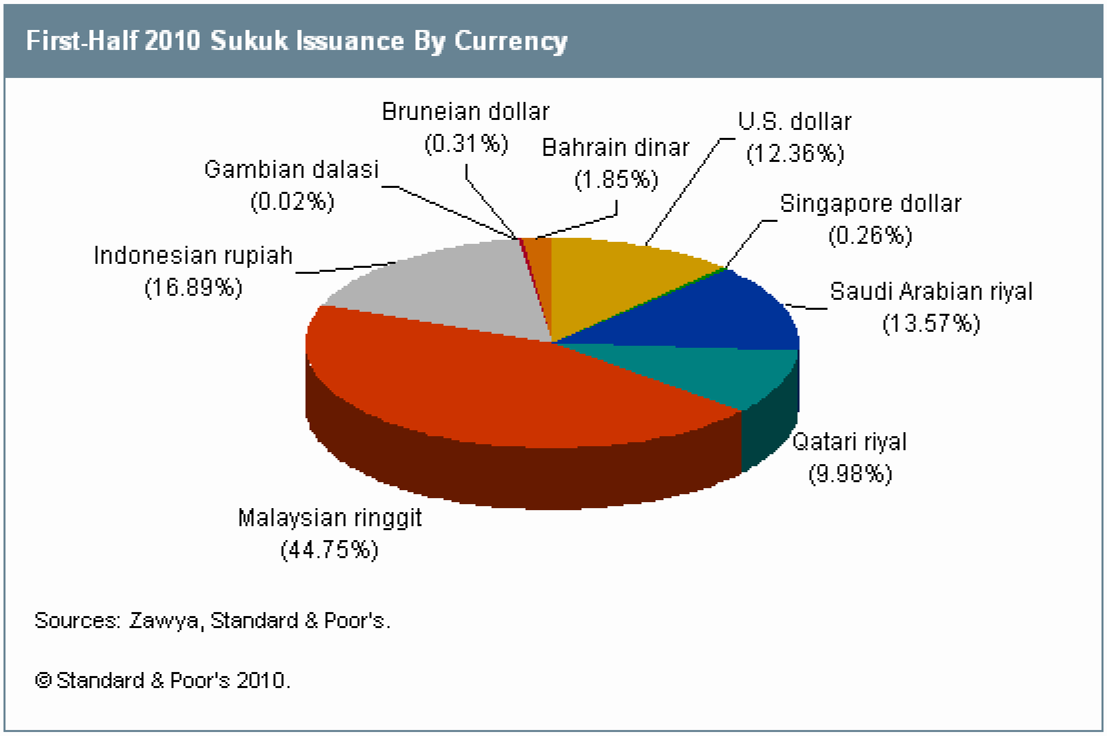
Chart 2



Dollar Issuance Is Still Low

Dollar-denominated sukuk accounted for a modest 12.4% of total issuance in the first half of 2010. The main reasons for this moderate performance, in our view, are issuers' moves to tap local liquidity pockets and dollar weakness. In our view, dollar issuance over the next six months will likely remain limited, given the ongoing dominance of Asia, and mainly Malaysia, in the market and the limited need for dollar-denominated sukuk. Further out, we think the dollar will likely slowly regain some lost ground as some issuers seek deeper access to capital markets than what local markets offer.

Chart 3



Governments Are Moving Increasingly Into The Market

In the past couple of years, we observed that the growth engine for sukuk issuance shifted from the corporate sector and financial institutions to governments and their related entities. This coincided with the global financial crisis and its impact on the world economy, coupled with some Sharia scholars' comments on the noncompliance of some structures with Sharia or Islamic law.

In our opinion, government issuance is a positive addition to the market because it is helping to create a sukuk yield curve against which private sector issuers can benchmark themselves. In addition, a dynamic short-term sukuk market--currently in the making in Malaysia--we believe could aid the overall expansion of the Islamic finance industry in addition to enlarging sukuk issuance. One of the major weaknesses in Islamic banks' asset-liability management, in our view, stems from the current limited available offering of short-term financial instruments for liquidity management. We consider that Malaysia is taking some steps to address the need for short-term instruments and that its moves, over time, could set a precedent for other countries aiming to develop more vibrant local Islamic finance activities. Still, we do not expect a dramatic change in the sukuk market structure in the foreseeable future while financial markets continue to heal from the impact of the global recession. Subsequently, assuming that economic recovery continues, we foresee new private sector issuers entering the market.

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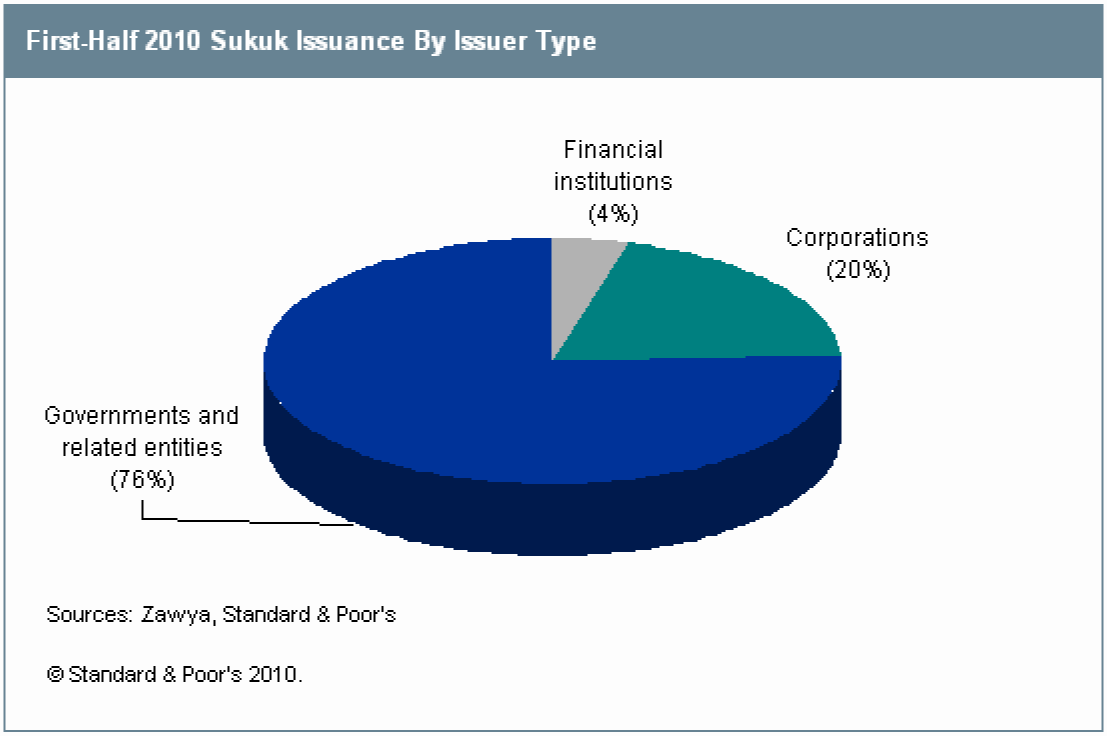
Chart 4



We Still See Some Obstacles In The Path To Expansion

In recent years, Standard & Poor's has identified what it sees as the main challenges for the sukuk market. Overcoming these, we believe, will contribute to determining the market's future.

Helping Market Participants To Learn About What To Expect If A Sukuk Defaults

We think determining how to deal with sukuk default is crucial for issuers and investors alike. Documenting defaults, although each one is unique, will help to create a track record on default procedures, including expectations for the proportion and timing of potential recoveries.

During the first six months of 2010, we witnessed one default on the sukuk market. According to public information, Kuwait-based International Investment Group (not rated) defaulted on its obligations toward investors on a $200 million sukuk issued in 2007 (for more information about our views on investment companies in the Gulf countries, see Related Criteria And Research) As regards past defaults, we understand that lawyers and investors are still in the process of discussing the restructuring of the Golden Belt 1 B.S.C. sukuk. The Investment Dar, which defaulted in 2009, seems to be progressing with its restructuring process. According to public information, creditors approved the restructuring plan in July 2010, which is now subject to the approval of the Kuwaiti Court.

Developing standardized interpretation of Sharia

Comments from some Sharia scholars in 2008 on the non-compliance of some sukuk already issued may well have dampened market growth to a degree. We understand that some issuers have become reluctant to use some structures as a result of these comments. Since 2008, though, we have seen some significant developments toward improved standardization. The most noticeable of these is Malaysia's new law, passed in 2009, giving the Sharia

Board of the Central Bank the status of final arbiter when it comes to matters related to Sharia compliance. Although moving in the right direction, the standardization process will likely be slow and difficult, in our opinion, given the necessity to align different parties and views. However, we think standardization will help the sukuk market's geographic expansion provide sought after parameters to countries that aim to develop Islamic finance locally. A recent example along these lines is the Dubai International Financial Center's project to create a standardized set of documents for sukuk issuance. This move could also help the reduction of the cost of issuing sukuk, in our view, which according to market participants is still high compared with similar conventional bonds.

Improving liquidity

Most sukuk to date have been issued in the form of over the counter (OTC) instruments that investment bankers developed to fit specific needs of issuers and then privately placed to meet specific needs of investors. The market is now moving toward listed instruments, be it on international markets or on local markets such as Dubai, Malaysia, or Saudi Arabia (under the newly created compartment for Sukuk at the Tadawul Stock Exchange). Listing sukuk on organized markets, we believe, is important for the liquidity of the instrument itself but also makes it easier to use for financial institutions seeking to broaden asset classes they use to manage their liquidity.

Standard & Poor's Ratings In The Sukuk market

To date, Standard & Poor's has rated sukuk worth more than $25 billion, based on its specific rating methodology for sukuk. Our role does not include structuring sukuk transactions, advising issuers or investors, or stating our opinion on the Sharia compliance of Islamic financial instruments.

Related Criteria And Research

- Standard & Poor's Approach To Rating Sukuk, Sept. 17, 2007
- Glossary Of Islamic Finance Terms, Jan. 7, 2008
- Gulf Investment Companies Face The Need To Rethink Their Business Models And Financial Policies, June 28, 2010
- Preliminary 'BBB+' Rating Assigned To Nomura Sukuk Ltd. 's Proposed US$100 Million Trust Certificates Due 2012, July 6, 2010

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