

5th Annual Islamic Finance Summit

Ijlal A. Alvi, International Islamic Financial Market

“SUKUK” – Developing a Secondary Market

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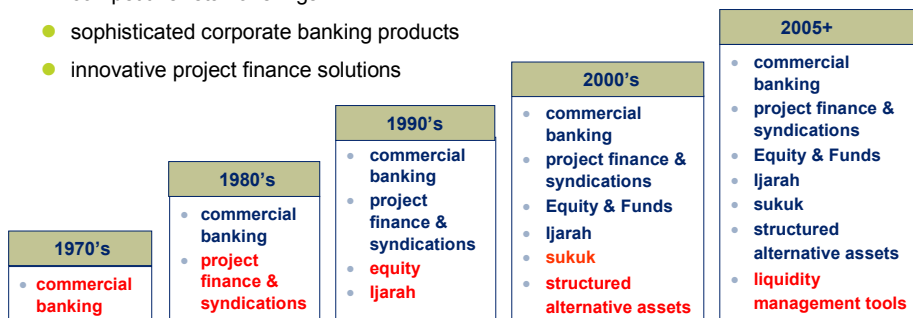
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Evolution of the Islamic Finance Industry & Islamic Capital Markets

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- Islamic finance has followed in the wake of innovations in the global financial services industry
- A natural progression of the Islamic finance industry
 - competitive retail offerings
 - sophisticated corporate banking products
 - innovative project finance solutions

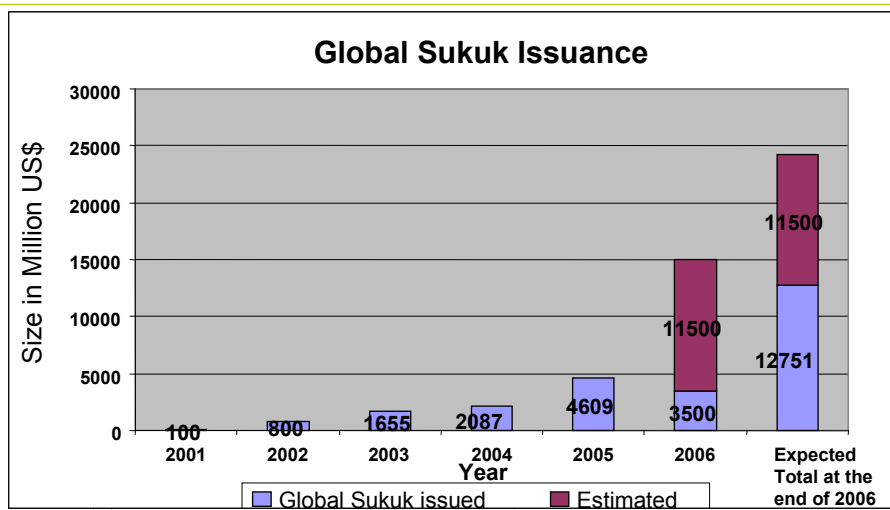


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Global Sukuk Issuance (Year)

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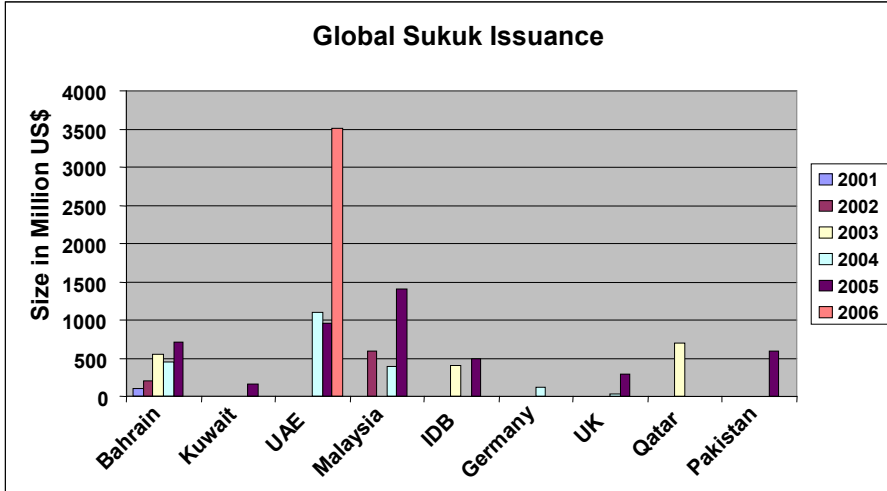


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Global Sukuk Issuance (Country)

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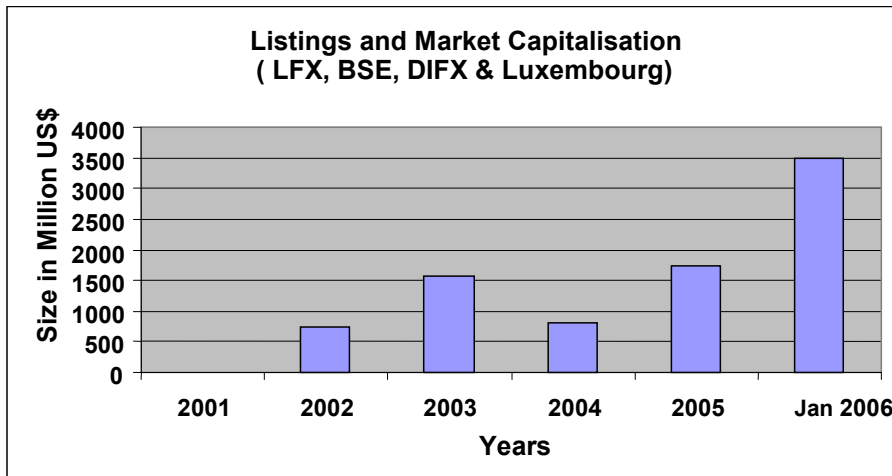


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Listing of Sukuk at LFX, BSE, DIFX & Luxembourg

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Growing Sukuk Investment Opportunities

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- Islamic financial institutions are seeking to diversify their portfolio and increase their portfolio size of tradable instruments with fixed income profile
- The industry requires Sukuk funds for retail distribution and once the concept becomes more popular, demand for Sukuk issues will surge exponentially
- Sukuk a Money Market instrument
- Islamic Inter-Bank or Short term Islamic Finance market can be developed through sukuku
- Appetite for Sukuk among Reserve Managers and non-bank financial institutions increasing
 - Central banks, state fund managers, insurance & takaful companies, are keen to invest in Sukuk issues as seen in all the sovereign sukuk issues.
 - Islamic FI's and also Western FI's



Sukuk Trend Analysis

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- According to one estimate, the sukuk investments in 2005 increased by 35% to approximately US\$ 9 billion as compared to 2004 (US\$ 6.7 billion)
- It is estimated that by 2006, close to US\$ 25 billion of Sukuk would be outstanding and by 2008, approximately US\$ 50 billion Sukuk will be outstanding
- Bahrain was among the first sovereign to issue a Sukuk in the world, opening doors to whole new asset class for the global financial community. They now issue about 24 sukuku a year which includes the Ijarah Sukuk as well as the short term-Al Salam Sukuk.

General Issues Limiting Secondary Market Development January 06

- Limited number of issuance that constrains active trading of these instruments in the secondary market
- Buy and Hold Strategy by major investors of sukuks due to lack of alternative instruments in this asset class
- Limited quality assets available for Ijarah securitization
- Limited Corporate Focus - Changing

Regulatory, Legal, Shariah & Other Issues January 06

- Lack of regulatory support from key jurisdictions
- Lack of initiative in developing a separate legal framework for sukuks vis-à-vis conventional instruments
- Lack of harmonization in existing Sukuk structures and difference of opinions among various shariah scholars, especially cross border
- Limited number of qualified personnel well versed in capital market issues both from shariah and commercial perspective
- Few Islamic investment banks lacking capability in structuring, originating or arranging capital market transactions



Constraints of Sukuk Investments

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- Major Constraints of investing in Sukuk instruments:
 - Secondary market illiquid due to absence of Critical Mass and Market Makers
 - Limited awareness about these instruments in the western market and some countries member jurisdictions
 - No benchmark for portfolio monitoring as available to conventional bonds – Sukuk Index
 - Limited supply of universally Shariah acceptable sukuk
 - Secondary market tradability of Balance Sheet based Sukuks



Sukuk - Development Requirements

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- To use Sukuk as a liquidity management tool
- Typical Sukuk tenors have been 3-7 years
 - There is a need for shorter tenor commercial paper type Sukuk
 - There is a need for longer tenor Sukuk (BMA 10 Yr Sukuk)
- There is currently limited supply of Sukuk in the market
 - Leads to buy-and-hold type of investors as there are limited alternatives if the investors were to dispose of their Sukuk
 - Central Banks borrowing requirement through Sukuk
- More Sukuk issuers need to come to the market
 - Sovereigns should initiate in jurisdictions that are new to Sukuk
 - Corporate issuers including project financing should form the bulk of issuers in any market (Example: Dubai Port Sukuks)
 - Use of balance sheet strength rather than real assets requirement



Sukuk - Development of Secondary Market

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- The sukuk market will be a developed market for Liquidity management when
 - There are issuers with differing credit qualities and Risk profile
 - There are Sukuk with maturities ranging from short-term to long-term
 - The investor base is broadened (via diversification of Sukuk products) to facilitate participation of more investors
 - Infrastructure and IT
- Industry standardization is needed for Sukuk products
 - Format of issuance i.e. Structures
 - Listing e.g. Bahrain, Luxembourg, others
 - Rating
 - Dual listing recommended to expand reach
- Market Makers & Brokers
 - Well defined role of Lead arrangers
 - To provide bid-offer prices on a continuous basis
 - Role of infrastructure institutions especially IIFM, support to market development bodies



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Role of Takaful

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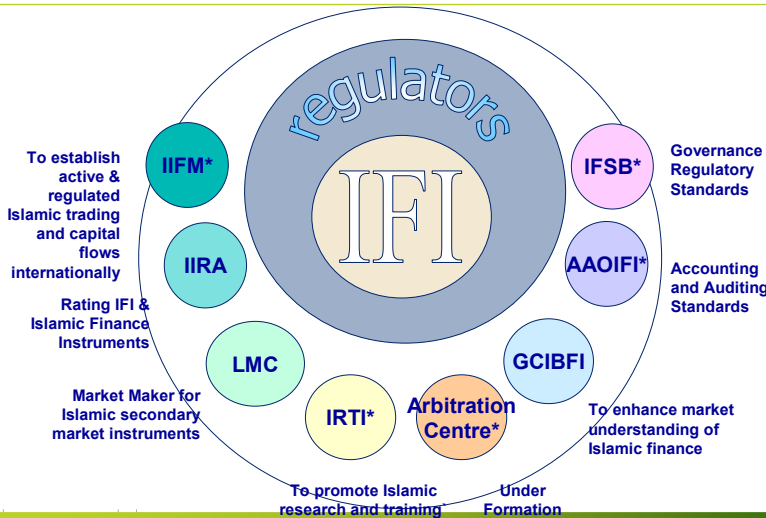
- The Takaful industry signifies an essential ingredient in the overall Islamic financial system and can be used for the development of secondary market
 - Mobilization of long term funds in the form of contributions and investment of these in the available Islamic investment channels
 - Provides protection against risk
 - Supporting overall growth and economic development
- In Malaysia Takaful penetration is almost 4 % vs 35 % for conventional insurance. This represents potential scope for the continued development and need for Takaful
- The Takaful market in the Middle East is growing at 15-20% per year



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The Islamic Financial Infrastructure



Infrastructure Bodies:

AAOIFI – Accounting and Auditing Organization for Islamic Financial Institutions

IFSB – International Financial Services Board

IIFM – International Islamic Financial Market

IRTI – Islamic Research and Training Institute

Arbitration Centre – Under Formation

Other NBF:

GCIBFI – General Council for Islamic Banks and Financial Institutions

IIRA – International Islamic Rating Agency

LMC – Liquidity Management Centre

Regulators – Central Banks, Monetary Agencies, Securities Commissions etc.,



Recommendations for Way Forward

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- Establishment of a Regulatory Framework
- Formulate and adopt widely acceptable Appropriate Accounting and Reporting Principles in all jurisdictions
- Required Infrastructure as available to conventional
- Uniformity of structuring and documentation
- Standardization and Shariah Harmonization
- Continuous review of earlier resolutions on Islamic capital Market issues which may have been the sources of divergence and harmonization
- Develop and update existing ruling by concerned bodies
- Definite need for innovation in Islamic Finance, like the convertible feature
- Liquidity Enhancement Measures
- Sukuk Index

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Recommendations for Way Forward Contd.

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- Research and Discussion on issues with direct implications to the development of Islamic Capital Market such as:
 - Sale of Debt for Debt (Bay al-Dayn)
 - Third party guarantee (in some of the global sukuk endorsed, the originator is the guarantor)
 - Risk in musharakah and mudarabah
 - Possibility of trading salam sukuk
 - Uniform Accounting and Auditing Standard
- Financial support to research and development and training institutions
- Diversification of financial instruments and encouraging research on product development
- Dissemination and availability of Islamic Finance Market information

Conclusion

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- In order to achieve the objective of a developed Sukuk secondary market, there should be:
 - Greater cooperation among the industry players
 - Better coordination to address the issue of Shari'ah harmonization
 - Greater participation from corporate sector and financing of Infrastructure projects
 - Key support by Regulatory bodies
 - Creation of International Sukuk Fund
 - Sukuk Index



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