# Desire for benchmarks to drive sovereign Sukuk issuances outside of traditional markets

**In recent years, the international Sukuk market has grown considerably, with Sukuk issuances surging not only by volume and value, but also in the geographical scope of the issuing markets. LEE IRVINE studies the Sukuk market, particularly sovereign Sukuk.**

**Many countries and territories have recently issued their first Sukuk and, in many cases, a sovereign or a quasi-sovereign issuer has led the way in those markets. This has been true of Malaysia, Bahrain, Qatar, Pakistan, Indonesia, the UAE, Germany (where the issuer was the state of Saxony-Anhalt), and Saudi Arabia (where the issuer was the IDB).**

Several factors are driving sovereigns to participate in the Sukuk market, including: the desire to establish a benchmark and to encourage the development of a corporate Sukuk market in the relevant country or territory, as well as the need to develop a legal and regulatory framework that recognizes and facilitates the issuance of Sukuk — especially in jurisdictions where Islamic principles are not enshrined in national law. As a result of these drivers, sovereign issuers constitute a greater proportion of the global Sukuk market than of the conventional bond markets. The value of international bond issuances reached around US$6.4 trillion in 2014, only around 10% of which was issued by sovereign and quasi-sovereign entities. In comparison, the value of international sukuk issued in 2014 reached US$114 billion, of which 85% was issued by sovereign and quasi-sovereign entities.

The UK issued Sukuk in 2014, the first western country to do so, attracting orders of more than GBP2 billion (US$3.05 billion) from global investors. The UK government's desire to secure London as a global hub of Islamic finance and, in the longer term, the center of the global financial system, largely drove the issuance. Similarly, Luxembourg issued Sukuk to diversify its status as a financial center and differentiate it from other European financial centers.

However, the expectation that sovereign and quasi-sovereign issuances would pave the way for corporates to issue Sukuk has not so far materialized. While several governments issued debut Sukuk in 2014 (the UK, Hong Kong, Luxembourg, Senegal and South Africa), no corporate has yet issued a Sukuk in any of those countries and — outside of Malaysia, Saudi Arabia and the UAE — corporate Sukuk issuances are relatively infrequent.

Despite the dearth of corporate issuances, the entrance of new issuers to the Sukuk market, particularly those governments representing strong credit, will nevertheless support growth in the Sukuk market over the longer term and help attract new investors to the sector, providing additional depth and liquidity to the Sukuk market.

## Review of 2015

While volumes of sovereign Sukuk have increased significantly over the last three years, as governments in Asia, the GCC countries, Europe and Africa have sought to tap the increased demand for Shariah compliant financial assets, the Sukuk market and, particularly the sovereign Sukuk market, has been more subdued in 2015. Declining oil prices have resulted in a slowdown in the economies of the main Sukuk-issuing countries of the GCC. Additionally, the Malaysian central bank, Bank Negara, ceased further issuances of short-dated ringgit-denominated Sukuk and looked for alternative ways to improve liquidity in its domestic financial market.

Industry observers expect these factors will result in a noticeable slowdown in global Sukuk activity in 2015, with S&P estimating that global Sukuk issuances in 2015 will only reach US$50-60 billion, a significant decline from 2014.

Nevertheless, certain Sukuk markets have remained relatively active during 2015, with Hong Kong issuing its second Sukuk of US$1 billion in May and Oman issuing its first sovereign Sukuk in October. The Southeast Asian sovereigns of Malaysia and Indonesia were also able to print record-equalling issuances, with Malaysia issuing a 30-year Sukuk (the longest maturity for a sovereign), and Indonesia issuing a US$2 billion Sukuk.

## Preview of 2016

While the sovereign Sukuk market has been relatively slow during 2015, a number of sovereigns look set to issue their inaugural Sukuk in 2016, including a number of African nations, such as Kenya, Ivory Coast, Tunisia, Niger and Nigeria, each hoping to follow the lead of South Africa and Senegal. Other sovereigns rumored to be considering debut Sukuk issuances in 2016 include Jordan and Kazakhstan. While some sovereigns have traditionally been constrained — from a structuring perspective — by a shortage of tangible assets, continued innovation in Islamic structuring (particularly in the corporate sector) has enabled issuances which utilize assets for the underlying structure which issuers would not previously have considered, allowing potential issuances by such sovereigns.

The majority of sovereign Sukuk have traditionally been issued in the local currency and targeted at domestic investors. However, as global investors become increasingly familiar with Islamic debt instruments, we expect an increasing volume of issuances of cross-border instruments from jurisdictions with predominantly domestic markets — such as Indonesia and Malaysia — as they seek to tap the increasing demand from international investors.

## Conclusion

In Malaysia and the Gulf, investors are familiar enough with Sukuk to demand little, if any, premium to buy them. Indeed, in the Gulf, in certain instances issuing conventional bonds has actually been more expensive for corporates than selling Sukuk. This situation, however, represents the exception rather than the rule. For the time being, we expect the desire for benchmarks, rather than simple funding requirements, will drive sovereign Sukuk issuances outside of these markets.

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