So Far

The journal of strategic thinking in Islamic finance

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The subject of this issue is:

How do we fix the current crisis in the Sukuk market?

Issuance has virtually dried up in the GCC – is this fixable?

Are there lessons to be learned from Asia?

Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

John Sandwick

Geneva, Switzerland

How do we fix the current crisis in the Sukuk market? Issuance has virtually dried up in the GCC – is this fixable? Are there lessons to be learned from Asia? Is the malaise afflicting the Sukuk market in the GCC likely to infect the rest of the Islamic finance space?

Many bankers observed with concern the failure to date of the year 2010 producing any breakout new Sukuk issuances. Most market participants are anxious to put the past behind them. Since the suggestion of Nakheel defaults of late 2009, and some very tough times for many other Sukuk backed directly or indirectly by real estate, the market has been waiting for a breath of new life from a signature new issue that would herald the beginning of a new era in Islamic finance.

Clearly the $500 million G.E. Capital Sukuk of November 2009 should have pushed the market forward. It was, after all, the first true international corporate Sukuk, a milestone in the industry. But it was so closely followed by the threats of mega defaults in Dubai and lesser ones in Kuwait that the wind was quickly taken out of the sails of the new issue market.

Of course the immediate past collapse of global market valuations, the impact on investor and issuer psychology from the global financial crisis, and general uncertainty have all played an important role in undermining confidence in new Sukuk issuance. And, those are the global contributors. Imagine the role of local factors, such as Gulf Finance House's woes, the dramatic collapse of revenue at

Arcapita, and the near disappearance of the region's private equity industry. Combined, there were plenty of logical reasons for new Sukuk issuance to come to a standstill. Both internationally and regionally we can understand why CFOs and treasurers were saying no to new Islamic bonds.

Yet despite this compelling story there is more than meets the eye. One has to look behind the scenes and dig a little deeper. Most of what follows is anecdotal, not hard news. But the results are clear enough.

In April and through early May 2010 the Golden Age Sukuk was shown to over 90 Islamic treasuries, mostly in Saudi Arabia and the Gulf but also as far away as Geneva, London and Kuala Lumpur. These Sukuk were created to purchase and then lease-back aircraft for the Thomas Cook Group, a 150-year-old British stalwart in the travel industry. Golden Age would have been Europe's first corporate Sukuk, another milestone in the industry.

For the first month of distribution the issue's lead manager, Wasatah Capital in Riyadh, insisted on a 7 per cent coupon and a highly restricted distribution policy to only Saudi buyers, strict conditions that were not relaxed until it was too late. Despite a parallel Thomas Cook issue of over $1 billion in 5- and 7-year bonds at very advantageous rates on the London Stock Exchange, Wasatah was unable to sell enough of the Golden Age Sukuk to achieve a closing. The Sukuk were withdrawn from the market.

This story is illustrative of failures in the Sukuk market, not on demand but on the supply side. In the case of the Golden Age Sukuk, the lead manager simply misjudged the market by a wide margin. What could have been a very successful new issue, making global headline news, was instead a distinct failure.

Importantly, the more than 90 Islamic treasuries that saw Golden Age could be divided into two camps. About half were mired in restructuring and workout situations with their own asset books, which were heavily invested in real estate, primarily within the Gulf region. As is well known collapsing real estate valuations in most GCC markets put enormous strains on treasuries, and Islamic banks no less than conventional ones. This half of the market could not bear any new issue purchases, as they simply did not have the liquidity to buy any new asset.

However, it is the other half of the market that is most interesting. Thankfully, many Islamic treasuries were prudent throughout the boom, carefully limiting their exposure to high-risk real estate developments. For the most part these treasuries were flush with cash.

And, importantly, they were and still are hungry for new Shari'ah compliant fixed-income securities. They have an average "sweet spot" for 3- to 5-year Sukuk that bear the highest yields possible for low-investment-grade ratings. They especially love a global Blue Chip corporate name not involved in real estate, since such issues are essentially nonexistent except for the G.E. Capital issue.

In fact, a vast pool of liquidity was readily available for the Golden Age Sukuk. The Sukuk would have very likely been oversubscribed had they been issued at market terms, so great is the apparent demand for new Islamic bonds.

Regrettably, the miscalculation of market conditions doomed the transaction. The market was seeking at least an 8.5 per cent yield to compensate for the deal's small size and the lack of a listing, rather than the 7 per cent being offered. And, the true market for Golden Age Sukuk was not at all in Saudi Arabia, but in the banks around the Gulf region, in Europe and further abroad. Late understanding of these market dynamics led to the failure of the Sukuk.

Why is this important? Because the Golden Age Sukuk could have been the first of many. Outside Saudi Arabia and the Gulf there are literally hundreds if not thousands of potential Sukuk issuers. They will not issue Sukuk until they see someone else go first. Think of the nearly Euro 1 trillion in new financing required by European corporations and governments in the coming 24 months, then draw a line to those that have abundant long-term fixed assets, and you will quickly see the potential for European Sukuk.

Treasurers and CFOs everywhere are in a constant scramble for new, diversified sources of funds. Just as Ford Motor issues bonds in Tokyo, Frankfurt and New York, so do most multinational corporations and many governments. For them a rich, reliable market for their Sukuk would be highly useful tool in their fundraising arsenal.

The demonstration effect is powerful. The G.E. Capital Sukuk's impact was limited by nearly immediate late-autumn negative news on Nakheel. Most issuers initially avoided the market. But by the early spring of 2010 the tides were beginning to turn. Dar Al Arkan's $400 million Sukuk showed demand was sufficiently strong. A blue chip brand like Thomas Cook was just what was needed to revitalize an otherwise moribund market, and its timing in the market was nearly perfect.

This makes the failure in issuing the Golden Age Sukuk even more troubling and the inability to provide market terms for the Sukuk was not just a loss for the dozens of professionals who spent inordinate amounts of time and energy preparing a world-class Sukuk; it was a loss for the greater Sukuk market itself.

Since the Golden Age Sukuk were pulled from the market we have witnessed the great negative credit events of June and July 2010, the most visible being the near collapse of Greek national bonds. Yet slowly the markets are returning, and hopefully in time to capture the attention of corporate and municipal issuers in Europe and elsewhere.

Many Islamic treasuries still have enormous demand for high-quality securities, but almost no supply. Until more Sukuk issuers come to the plate with correctly priced deals, we will not go back to the good old days. European corporations and municipal borrowers in line to access the Eurobond market could easily also tap the Sukuk market. When they recognize the potential in diversifying their funding with a very reliable new source of capital, they may start a trend toward European and eventually global Sukuk issuance.

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