SHARED RISK & REWARD

The Sharing Risk Newsletter

March 4, 2012

Issue 88

IN THIS ISSUE

Sharing Risk dot Org

Sharing Risk
1500 SW 1st Avenue, Suite 910
Portland, Oregon 97201
Website
Blog
Twitter

Are sukuk more expensive than conventional bonds?

One of the running debates in the Islamic finance industry is the issue of cost of Shari'ah-compliant products versus conventional products. Whether it is an Islamic mortgage, Islamic structured product or a sukuk, the conventional wisdom is that there is a premium associated with Islamic finance (which I discussed last December in a blog post).

However, a story from Bloomberg, quoting the VP at SJS Markets Ltd., Samer Mardini, puts a figure on this premium: 120 basis points or 1.2%. The estimate from Marini estimates the coupon required to sell 5-year sukuk at 5.5%, significantly higher than the yield on conventional bonds of the same maturity according to Bloomberg.

Perhaps this also puts some context behind the UK Treasury's decision to again decide sukuk don't offer value for the cost. In an era where debt levels are rising and there is heightened attention paid to the sustainability of debt, few Western sovereign issuers are going to opt for a more expensive option, especially if the spread over convention debt exceeds 100bps.

The question then follows: where is the spread coming from and is there a way to reduce it? The answer to the first question, is two-fold. Many people would immediately point to the additional legal and financial structuring fees, and this is a contributing factor, but I think that investors demanding extra yield is probably a more significant factor.

I place a lot of responsibility at the feet of the secondary markets and the lack of development of liquid markets for the additional cost. This was attributed as the cause of several Indonesian sukuk auctions back in 2010, despite the rapid growth in the economy of Indonesia. Due to illiquidity in secondary markets, investors demanded a spread of 50bps over conventional bonds, which are more liquid. The article linked above quotes a fixed income analyst at Mandiri Sekuritas: "The main problem in sukuk auctions is liquidity".

The liquidity issue is a difficult one to resolve, but changing conditions in sukuk primary markets (where sukuk issuance has surpassed pre-crisis levels) may indicate that at least one piece

SUKUK COSTS (cont.)

is fitting into the puzzle: supply. If there is sufficient supply of new issues, then investors may be more willing to part with the sukuk in their portfolio because they know they can replace it with a different sukuk, deepening liquidity in secondary markets.

While this does provide some hope, there are still other obstacles blocking the path to a narrower spread between conventional bonds and sukuk. Even if one excludes the legal costs for structuring a sukuk, it will still be more costly for investors because each sukuk is different and the prospective purchasers will have to spend more time reviewing the structure, rather than focusing on whether the issuer is risky or not.

There are likely to be cases where a custom sukuk is the only way to go, but there will be many more instances where it will just add cost and complexity to the issuer and to the purchaser. I like the idea that was proposed for IIFM and Hawkamah of creating a template for an ijara sukuk. IIFM has experience in the past creating standardized contracts (some of which have been more successful than others), and ijara sukuk are probably the most common structure for issuers.

There is no guarantee that either a template for an ijara sukuk, nor a more liquid secondary market would lower spreads to zero, but better to tread down these paths and see if it makes an impact than to keep marching forward down the current path.

THE AMERICAS

Updates from the Americas

- The Malaysian subsidiary of Bellingham, Washington-based fund manager Saturna Capital, manager of the Amana Funds, was selected as the portfolio manager for the Crescent International Equity Fund. The fund—which will be launched later this year by Australia-based Crescent Wealth—represents a new area for Saturna and its Malaysian subsidiary it acquired in 2010. It also represents the first fund Saturna manages outside of the US.
- South Dakota's state House of Representatives passed a law on February 14th that was subsequently passed by the State Senate on Wednesday and passed on to the governor that would prohibit the courts and state government agencies from enforcing "any provisions of any religious codes". The law follows a failed attempt in 2011 to amend the securities laws to ban Shari'ah-compliant products, though that law was attacked for its vagueness and potential unforeseen consequences. The current bill was introduced at the end of January, nearly the same time as the legislature passed a non-binding

THE AMERICAS (cont.)

measure encouraging South Dakota public schools to provide academic instruction on the Bible. The irony is apparently lost on the supporting members of South Dakota's legislature.

Until next week,

Blake Goud
blake@sharingrisk.org
Principal, Sharing Risk

FROM THE BLOG…

WEDNESDAY (Feb. 29)

Green sukuk and oil exports

Bloomberg has an article about the prospects for a green sukuk coming out of the GCC (with suppport from Australia's National Australia Bank and Abu Dhabi-based Clean Energy Business Council). One thing I noticed in the article that, while it makes sense if you step back, seems odd at first glance was the statement that: "Building a renewables industry allows more crude to be exported, said Indraj Mangat, a partner at Eversheds LLP".

The idea that renewable energy development would be promoted in order to export more crude oil sounds contradictory, but it is not necessarily so. In 2008, 4 of the top 10 countries in terms of carbon emissions per capita were located in the GCC (Qatar [1], UAE [3], Bahrain [5], Kuwait[7]) with Saudi Arabia [13] and Oman [14] not far behind. Although some destinations for the oil and gas that would otherwise be exported (e.g. US and Canada) are not much better in terms of carbon emissions per capita, many destinations are (e.g. European nations, South Korea, Japan and China).

The per capita carbon emission might not be the ideal measure (carbon emissions per unit of GDP is probably better, and comes up with slightly different results): Qatar [18], Bahrain [20], Kuwait [25], Saudi Arabia [26], UAE [36], Oman [39]. The real change here is whether the export markets are less carbon intensive than the GCC (which would make the shift away from domestic consumption of oil and gas towards renewable): USA [54], UK[115], Germany [92], France [144], Japan [96], South Korea [58], China [10]. Substituting oil that is sent to China will not reduce the overall carbon footprint because it will be used relatively inefficiently for creating GDP, and there will be marginal savings for oil sent to the US. However, South Korea, Japan and European countries will convert the carbon emissions from the barrel of oil more effectively in creating GDP and there will be a net carbon savings relative to the GDP that is created.

TUESDAY (Feb. 28)

TAQA goes east with sukuk

Abu Dhabi National Energy Company (TAQA) has issued a 10-year ringgitdenominated sukuk, which was met with strong demand, continuing a trend for GCC issuers to look east to Malaysia for capital to diversify funding sources. In the past, I have suggested that some issuance in ringgit may be an effort to speculate on the direction of the Ringgit versus the US dollar (to which GCC currencies are pegged). This has been speculation on my part (with the ringgit-dollar exchange rate at the highest point in at least 6 years, a fall in the value of the ringgit would reduce their obligations in principal and profit). However, it appears that TAQA does not have this objective in mind since they swapped the exposure into US dollars at a rate of 5.3% (the ringgit rate on the sukuk was 4.65%). The 10-year tenor of the sukuk is longer than most of the issuance out of the GCC (where 5 years is favored) so perhaps it was the ability to find demand for longer-dated sukuk (perhaps based on a more liquid secondary market) was the reason for looking to KL.

SUNDAY
(Feb. 26)

Shared Risk & Reward (fka the Sharing Risk Newsletter)

I have been writing the Sharing Risk Newsletter now since May 2010 (and the blog since September 2006). It has been, and will continue to be, an email newsletter (which you can sign up for on the right hand side of my blog under "Weekly Newsletter"), although I have started to put the archives up on my website, www.sharingrisk.org. The newsletter was originally created because I received an email from blog readers who wanted a way to receive the blog posts by email (which is now automated; you can also sign up on the right hand side of the blog under "Subscribe via email"). When I started it, I added an additional bit of commentary (an archive of which I am adding to my website).

Despite having now sent out 87 issues of the newsletter, I have not yet had the time to come up with a name for the newsletter. The 87th issue changes this. I'm still working on formatting (please send me suggestions at blake@sharingrisk.org) but I have decided on a title: "Shared Risk & Reward".

Shared Risk & Reward originated from the name of the blog and website (Sharing Risk), but added Reward because Islamic finance exists to make a profit, and recognizes that making a profit entails taking a risk. The focus of the newsletter has been, and I hope will continue to be, finding ways where Islamic finance can continue to recognize the intimate connection between risk and reward in finance, and its connection with the underlying economic activity that finance is meant to support. I also believe that the newsletter and the blog should call out Islamic finance when it emulates Icarus and flies too close to conventional finance's sun, melting the wax that holds its feathers together.

For those readers who are not already subscribers, I have put the latest version of the newsletter up as a pdf. I will continue to put up back issues on my website with about a month's lag, but if you want to get the latest updates on developments in Islamic finance you should subscribe to the newsletter. It will also include the previous week's blog posts if you miss any. It typically comes out Sunday evening US time, which gives me a little breathing room to take in the previous week's news as well as think more about the previous week's posts to give a refreshing complement to the blog. And, it's free.