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Green sukuk and infrastructure development in the Middle East

Recently, an article on the Knowledge@Wharton (Wharton is the business school at the University of Pennsylvania) discussed the infrastructure challenges facing the Middle East and suggested that it was more important to the region than oil and gas. While the article had only passing mention to Islamic finance (a final paragraph mentioned the development of the industry over the past 30-40 years), it should receive a higher priority.

The article included a quote from Hesham Tashkandi, senior operations leader at GE Energy in Saudi Arabia: "The UAE does not have as much oil as other countries, so it may find that it would be better to burn the gas and oil itself, rather than continue to trade on the global market". This is in contrast to the perspective that I described with reference to the prospects for a green sukuk. My comments were based on the sentiment expressed by Indraj Mangat, a partner at Eversheds LLP: "Building a renewables industry allows more crude to be exported".

The basis for my blog post was that the GCC would be well served by developing more renewable energy generating capacity (financed through a green sukuk) because the countries in the region are quite energy and carbon intensive, when measured by carbon emissions per unit of GDP. The six countries in the GCC are among the top 15 in carbon emissions per capita (they are ranked slightly lower in the emissions per unit of GDP). If they shift their own use away from oil and gas, and instead export the gas to more efficient users of energy, then the aggregate carbon emissions should decline.

However, a green sukuk could be used to finance more than just renewable energy: the Wharton article describes the need for more technology to deliver clean water (50% of the population in the Middle East do not have access to clean water). Either (or preferably both) renewable energy generation and water treatment and distribution facilities could be developed with financing raised through a green sukuk (which is being promoted by the Climate Bonds Initiative).

A sukuk for a solar farm or water treatment plant would be a good fit: a large amount of capital is needed up front and the project would have a tangible asset to back the sukuk, which would make periodic payments based on the sales of either water or electricity it generates.

The one potential difficulty in getting new projects financed with sukuk is that they would most likely have to be istisna'a-ijara sukuk. During the istisna'a phase, the sukuk would not likely be tradable. However, once the project is constructed, it would be an ijara sukuk and most likely tradable. A solution to this potential problem would be for the sukuk to be issued by a company that has already operating facilities looking to build new capacity. The sukuk could then be an ijara sukuk on the existing solar farm or water treatment facility with the proceeds used to construct additional capacity.

With sukuk markets surging, it seems like now is a good time to expand into new areas for Islamic finance. The renewable energy and infrastructure to provide clean water are areas that would have a positive social impact, in addition to being financially viable. Much more useful in my opinion than the pre-crisis focus on over-building bigger and more lavish luxury homes to meet highly uncertain demand (as the post-crisis crash in real estate in some areas has demonstrated).

Updates from the Americas

TCW to manage NCB Capital's Shari'ah-compliant international equity funds
Trust Company of the West (TCW), Amundi and NCB Capital, the Saudi asset manager formed an alliance to manage NCB Capital's international Islamic equity funds. Perhaps the entry of a large US-based asset manager into the Islamic funds market can make Islamic finance more familiar to Wall Street, which has lagged other Western financial centers in Islamic finance.

UM Financial sale process hits a roadblock
The UM Financial bankruptcy process hit a snag when the 9 offers from 7 bidders came in under the amount UM Financial owes to Central One Credit Union. As a result the receiver rejected the offers and is reviewing the process of the sale of the portfolio. Filings with the bankruptcy court say that the bidders and Grant Thornton engaged in weeks of negotiations, but could not find an acceptable price to all parties.

It is a bit surprising that the receiver expected to receive full value for the portfolio, a snag that derailed previous negotiations for the sale of the portfolio before the receivership. Grant Thornton continues to administer the portfolio and is considering its options for realization of the portfolio's value.

Until next week,
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FROM THE BLOG…

SATURDAY
(Apr. 7)

TheCityUK report on Islamic finance

TheCityUK, the trade group for London's financial services industry released its annual report on the Islamic finance industry, showing the growth of the industry to $1,130 billion in assets at the end of 2010 with an estimated growth in 2011 to $1,289 billion. This report is useful because at this point there are several years of report to look for trends, in part to identify areas where the data are more or less likely to reflect reality. The Islamic finance industry is notoriously opaque, so hard data, even data on the aggregate size of the industry, are unreliable.

For example, one of the areas that I am skeptical of the data is the inclusion of the Iranian financial institutions. The reason why I am skeptical of the Iranian data is that, despite accounting for 36% of total assets and facing tight international sanctions, there has been no spillover to the rest of the Islamic finance industry in terms of growth. Viewed a different way, as of the end of 2006, Iranian Islamic financial institutions had $154.9 billion in total assets as of the 2008 version of this same report. By 2010, this had increased to $388.0 billion, an annualized growth rate of 26%. The Iranian economy was growing during this period (pdf, page 5), but with international sanctions tightening, and limited financial market development and integration with other markets for Islamic finance, it is unlikely, in my opinion, that the Iranian Islamic finance industry grew at a more rapid pace than the Islamic finance industry in the rest of the world. Another factor that casts doubt on the rapid growth is that the banks that would represent much of this growth are specifically targeted by sanctions, and are also large banks (it is much harder for a big bank to achieve and sustain such a high growth rate).

However, the rest of the report is worth reading because there are few other sources of data on the industry as a whole. For example, a new table this year (I think) shows a data series of the average management fee of Islamic funds. The interesting thing in the table is that the average management fee has been declining from 2006 to 2011Q1, from over 1.5% to just above 1.0%. This is a positive development for Islamic investors, but may hamper the entry of new fund managers. However, one area where growth is due is in fixed income funds, which only make up 6.8% of total assets under management in Islamic funds. The demand for Islamic fixed income funds is likely to be strong, since there are few offerings and it is difficult for all but the largest investors to invest directly in a portfolio of sukuk. The upside from the fee perspective is that most conventional fixed income funds charge lower management fees than equity funds, so prospective entrants will be less concerned with the dropping average management fee in the Islamic fund space.

THURSDAY
(Apr. 5)

Is Islamic finance beneficial for non-Muslims?

Reviewing a little bit of the backlog of articles I have that I passed over in the past few weeks, I found two that I think get at an important but difficult topic with Islamic finance: how open Islamic finance is to non-Muslims. The first article was one from Rushdi Siddiqui discussing somewhat controversial comments from Badlisyah Abdul Ghani, CEO of CIMB Islamic, that conventional banks should not be allowed to issue sukuk (except for multilateral development banks).

Rushdi counters with a number of good articles about why scholars have allowed conventional banks to issue sukuk and for Islamic banks to use conventional banks as counterparties for their commodity murabaha. Another article comes from Faizy Syed, who focuses his article on India, with reference to other countries where Muslims are in the minority, is more concerned with the role Islamic finance can play within non-Muslim majority countries.

I have a slightly different view from either, but that does not mean it is necessarily contradictory of their perspectives. Islamic finance is in fact present in many countries whose Muslim minorities may be too small to support an indigenous Islamic finance industry, and in many of these countries the Islamic finance industry is not focused on the local market. For example, Ireland and Luxembourg are often held up as Western nations trying to attract Islamic finance. However, they are no more interested in attracting Islamic finance for a domestic purpose except to bolster their status as offshore locations to facilitate international finance.

These countries all see Islamic finance as no threat, and really no different in purpose in the economy from conventional finance and see the potential to expand their market share compared to the Cayman Islands, Guernsey or Bermuda as low-tax-rate countries that are also used to facilitate international transactions. Both Ireland and Luxembourg are viewed as attractive because of their experience serving as domiciles for UCITS directive compliant funds offered across the European Union.

While in that sense, Islamic finance has integrated itself in the international financial market, which is good for its development (something that Rushdi mentioned as well). However, the other idea that is often expressed is that Islamic banks because they are guided by Islamic principles are therefore beneficial for all people, including non-Muslims. I think the connection is more tenuous there. Most Islamic (retail) banks operate to provide Muslims with Shari'ah-complaint financial services, which is good on its own by promoting greater financial market integration for Muslims.

There are also widely cited examples, such as the high penetration of Islamic banks in the non-Muslim population in Malaysia. In many cases this has arisen because Islamic banks can offer cost-competitive products and may also include some provisions (such as non-recourse mortgages in some countries) that conventional banks choose not to. This is the best way I think for Islamic banks to expand their take-up by non-Muslims.

One of the least effective, in my opinion, is to say that Islamic banks were insulated from the financial crisis by virtue of their inherent 'better-ness', or by repeating claims that Islamic banks are just 'better' than conventional banks (even while the Islamic banks are replicating the conventional banks' business models with higher fees). There are many intriguing possibilities for Islamic finance that are appealing to many non-Muslims (like me), but they are based on specific cases, not broad generalizations.

One of the things that allowed the financial sector to take over the American (and to some degree global) economy before the financial crisis (as measured by the share of total profits generated by financial institutions compared to the economy as a whole) was that it believed it was (to borrow from Goldman Sachs' CEO Lloyd Blank phrase) "doing God's work". That it was inherently productive to the economy as a whole. Instead, the correct description is that finance has a purpose which is productive for society as a whole (allocating capital to productive enterprises). When it strays from this role (for example, by encouraging subprime mortgage lending to fill securitizations and re-securitizations, or by contributing to a real estate bubble topped off with newly created islands shaped like palm trees), it is not acting productively.

There is nothing inherently better about Islamic finance than conventional finance, and asserting its superiority compared to conventional finance as if the two could be compared each as a single monolith, is a fruitless discussion (and one that is unlikely to expand its appeal for non-Muslims who may not really understand what Islamic finance even means). There are good products and bad products and the former can offer something to everyone that will help finance return to its productive roots and perhaps also improve it. The latter, however, are not any better than the bad conventional products, or really any worse. It is just that the conventional financial industry has a much greater reach so the bad products in conventional finance spread faster and more widely and thus have a much greater impact on the global economy.

Instead, the path forward, if creating finance that is good and beneficial for all, is to ask "can Islamic finance offer a product that is cost competitive with conventional finance, and which offers something of value to consumers that conventional finance does not?". If so, let's proceed post-haste. If not, there may still be value (e.g. integrating Muslims into the financial system), but just recognize that the potential for the product to get widespread appeal among non-Muslims. It is not necessarily a bad thing to develop a product that may only appeal to Muslims, if it can bring them into the financial system in a way that benefits them. But this is a far cry from the idea that Islamic finance in its entirety is inherently better than conventional finance and therefore should appeal to all people.

TUESDAY
(Apr. 3)

Malaysia's Security Commission-OCIS forum details shared

I was critical recently about the Malaysian Securities Commission and the Oxford Centre for Islamic Studies holding a closed door forum, then issuing a press release about it with few details. Whether or not it was in response to my post, I was nonetheless happy to see a more complete discussion in the Malaysian International Islamic Financial Centre (MIFC) email newsletter. I have posted it below. As I said in the post, transparency is important in Islamic finance and, while it does not have to be applied in every case (there are valid reasons for not everything to be disclosed all the time, but usually in those cases there is not a press release issued), it can benefit everyone to bring discussion on the big issues in Islamic finance into the public view.

I think there are some very interesting ideas proposed, not all of which are new, but which need to be repeated until they are addressed. In particular, I think that Neil Miller's comments on sukuk secondary markets should be a focus in liquidity management (as Ijlal Alvi mentioned when discussing the use of sukuk as collateral in tri-party repo). There are a lot of areas in the sukuk market that need development, and among the points that the summary describes from Neil Miller, the most important in my opinion is adding depth and breadth to the sukuk market (an issue I have discussed several times, including one rough estimate at the potential for sukuk issuance in the GCC if it reached the size relative to the economy as Malaysia, and if corporate issuers in the GCC became more active).

There can be little development in sukuk markets and in sukuk-backed repo transactions if there are not enough sukuk issued. In order to develop trading markets, there should also be a variety of sukuk (many different issuers, tenors, ratings, etc) to make it more worthwhile for investors to sell one type in order to buy another (to move from lower to higher quality, or from a longer to shorter maturity).

There are many thought provoking questions raised, even in the short article about the forum, but having the subjects revealed publicly should start many more discussions than the original press release will.

PRESS RELEASE
Solutions for Liquidity Management in Islamic Finance
The Securities Commission Malaysia (SC) and the Oxford Centre for Islamic Studies (OCIS) organized the 3rd SC-OCIS Roundtable which was held at the Securities Commission, Kuala Lumpur on 12-13 March 2012. The theme for this year's Roundtable was 'Solutions for Liquidity Management'.

The Roundtable had three main sessions each comprising two presentations, two respondents and Questions & Answers and a Chairman. There was also an opening session with keynote speeches and a concluding session where Chairs summed up the proceedings of each respective session and made recommendations on 'Solutions for Liquidity Management' going forward.

The session topics included 'Reaching Consensus on Sukuk Trading'; 'Developing Participatory Instruments as Liquidity Tools'; and 'Commodity Murabahah and its Variants' respectively. For the benefit of MIFC Community members and EPICENTRE readers, this Briefing highlights the main issues and conclusions that were discussed during this closed-door Roundtable.

The Session on 'Reaching Consensus on sukuk Trading' saw two robust presentations - one by Neil Miller, Global Head of Islamic Finance, KPMG, Dubai, who highlighted several constraints in sukuk trading and suggested some solutions which would help overcome some of these constraints to achieve liquid markets; and the other by Ijlal Alvi, CEO, International Islamic Financial Market (IIFM), Bahrain, who proposed the use of sukuk as a form of collateral at both a domestic and cross-border level, and the development of a Three-party Islamic alternative to repurchase contracts (REPOs) based on the principle of I'aadat Al Shira'a - the lack of which is considered a major impediment in the development of an Islamic inter-bank market.

Neil Miller suggested several solutions for sukuk trading to develop further:
- A need for a steady supply of liquid securities with different risk profiles and maturities - in other words more depth and breadth in the market;
- The emergence of cross-border liquidity framework;
- Greater integration of Islamic financial centres to promote a vibrant secondary market;
- A regulatory environment that promotes meaningful disclosure and transparency;
- The establishment of a bespoke trading platform to facilitate the listing and subsequent trading of a wide universe of sukuk and other Shariah-compliant instruments; and
- The inclusion of built-in controls in the proposed Platform to prevent the market from misusing the trading of sukuk or controlling junk sukuk trading.

Ijlal Alvi alluded to various AAOIFI standards which allow for the addition of extra collateral. On this basis he suggested the use of sukuk as a form of collateral. He highlighted the following considerations:

- Understanding the Shariah issues, for instance under the Shariah collateral must be in kept in a separate account;
- Taking security, where under the Shariah it is not possible to rehypothecate securities as practiced in conventional banking;
- Margin maintenance and accounting treatment; and
- The establishment of an International Triparty Agent which he said was essential to be developed in Islamic finance jurisdictions.

The Session on 'Developing Participatory Instruments as Liquidity Tools' comprised presentations by M Iqbal Asaria, Associate Afkar Consulting Ltd and Visiting Faculty, CASS Business School, UK and Rushdi Siddiqui, Global Head, Islamic Finance & OIC Countries, Thomson Reuters.

Iqbal Asaria warned against the debt-based market fundamentalism that spurred the growth of the West. Islamic finance grew within this debt based system, creating pressure for Islamic banks to replicate and mimic the conventional products. He questioned the current state of Islamic finance which is still plagued by lack of standardisation, continued use of Inah and Dayn, the growth of Tawarruq and Commodity Murabahah. There is little progress in cross-border liquidity and challenges relating to Basel III. He urged among others; Islamic finance should move towards equity oriented financing, Islamic finance should use the sukuk experience to develop and participatory instruments such as Corporate Musharakah Certificates.

Rushdi Suddiqi on the other highlighted the need for sophistication and efficiency in the commodity murabahah platform in the areas of such as news data , central counterparty clearing entity, greater use of electronic processes and the introduction of a screen-based platform for trading.

The session on 'Commodity Murabahah and its Variants' comprised presentations by Associate Professor Dr Said Bouheraoua, Chief Academic Officer and Dean, International Shariah Research Academy for Islamic Finance (ISRA) Malaysia, and from Khairul Nizam, Assistant Secretary General, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Manama.

The conclusions were that:

- Commodity Murabahah is acceptable to manage solutions in liquidity management of an Islamic bank despite varying Shariah views;
- AAOIFI recognises Tawarruq subject to pre-conditions and that regulated Tawarruq is an alternative such as the Bursa Suq al-Sila' platform;
- It is imperative to have mutual recognition on Shariah positions amongst jurisdictions to facilitate cross-border transactions to facilitate liquidity management;
- Liquidity management is intended to preserve the 'health' of the Islamic banking system that will allow Islamic banks to serve the society/public and this is consistent with the objectives of the Shariah (Maqasid al-Shariah); and
- There should be much greater cooperation and contact between market practitioners, Shariah scholars and economists in addressing the above issues.