SHARED RISK & REWARD

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♦ **Pension funds complain of sukuk shortage**
Sukuk are widely believed to be in short supply almost everywhere in the world, but it is relatively surprising to hear of sukuk shortage in the largest market for them, Malaysia. However, it also suggests that there is a large source of funds looking for sukuk which could support continued rapid growth in sukuk issuance.

♦ **From the blog…**
An Islamic SIV?...Islamic finance should lead on diligence of offshore companies

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A shortage of sukuk…in Malaysia of all places

Even in the face of record issuance, pension funds in Malaysia are reporting that they are being held back from expanding their sukuk holdings by a shortage of investment-grade sukuk. This Bloomberg article is particularly surprising since the largest of the pension funds (Malaysia's Employees Provident fund holding $153 billion of the total $192 billion managed by the pension funds commenting for the article) is located in Malaysia, which has the largest and deepest sukuk market in the world (in terms of total issued sukuk and secondary market liquidity). Total sukuk outstanding that are domiciled in Malaysia as of July 29, 2011 was $112.3 billion, nearly 63% of the total outstanding sukuk globally.

The funds mentioned in the article are:

- Employees Provident Fund (Malaysia, AUM: $153bn)
- Kumpulan Wang Persaraan (Diperbadankan) (Malaysia, AUM: $27bn)
- Jaminan Sosial Tenaga Kerja (JAMSOS) (Indonesia, AUM: $11.5bn)

In addition to pension funds, takaful providers (of which Malaysia has several), are likely to have the highest demand for long-term investment-grade sukuk to meet their longer-term investment mandates, while banks and other financial institutions are likely to demand domestic sovereign debt, in order to minimize the capital they are required to hold (generally risk weightings for domestic sovereign debt is lower than for domestic investment grade corporate bonds or sukuk, meaning the banks must hold less additional capital against their sovereign bond or sukuk holdings than if they invested in similarly-rated corporate sukuk.

If the institutions (pension funds and takaful firms) who typically have long-term (if not hold-to-maturity) holding periods are finding too little supply of sukuk than they are also likely to hold onto whatever sukuk they are able to buy, which will effectively remove it from the secondary market. This will most likely constrain the development of secondary market liquidity because other holders of sukuk are less likely to sell it into (less liquid) secondary markets fearing that they will either not be able to find a replacement sukuk or will have to pay up to get it.

The story of low supply exacerbating illiquidity in secondary markets does happen (most notably in the lack of secondary market liquidity for sukuk in the GCC before the financial crisis). It is more surprising that pension funds in Malaysia are finding limited supply and therefore limiting their holdings of domestic sukuk while looking outside of the country for sukuk (Bloomberg reported that they were planning to increase their holdings of non-Malaysian sukuk from $1.7 billion to $3 billion by 2013).

If the largest market for sukuk is experiencing a lack of supply, then there is likely a much larger market potential for sukuk. If the market can expand to provide sufficient or near-sufficient supply for long-term buy-and-hold investors, than there will be more supply available for shorter-term investors (including sukuk funds). The Ernst & Young Islamic Funds & Investment Report 2011 (pdf) broke down the AUM in Islamic funds by asset class (data as of 2010), which showed that fixed income funds are a much smaller part of the Islamic funds market than the conventional fund market. The E&Y report showed sukuk funds representing 7.8% of the total assets under management in the Islamic funds industry. For comparison, the trade group for US mutual funds, the Investment Company

Institute showed that 20.4% of all mutual fund assets were in just taxable bond funds (excluding assets held in municipal bond funds, or in money market funds, which make up 4.2% and 21.4% of all mutual fund assets in the US, respectively, compared to just 1.1% of Islamic funds' assets).

These funds will be drawn into the market by liquid secondary markets because they are much more likely to trade than the banks, pension funds and takaful providers. However, if there are shortfalls in supply even in the largest markets, then the sukuk funds will develop slower than they could with greater liquidity. This demonstrates again the need for the Islamic financial industry to continue to attract more investment grade issuers (both sovereign and corporates) to the market.

Until next week,
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FROM THE BLOG…

WEDNESDAY
(Apr. 11)

Could off-balance sheet investment accounts become Islamic SIVs?

When I was going to look at the latest AAOIFI consultation paper on real estate, I noticed that I had missed a consultation paper (pdf) whose comment period expired recently that focused on the accounting treatment of investment accounts that use mudaraba and wakala.

At the heart of the changes or refinements (not being able to look up the existing standard on the web, I cannot compare the new with the old) is that restricted mudaraba and wakala deposits will be treated as off balance sheet assets, while unrestricted mudaraba will be treated as on balance sheet assets. In general the distinctions between how each type of account is treated (restricted mudaraba are investment accounts that are limited to a particular investment, unrestricted mudaraba are invested at the discretion of the bank, while wakala accounts are agency accounts where the financial institution acts as agent).

One area of concern I have is that the standards as they relate to off-balance sheet accounts (restricted mudaraba and wakala accounts) are relatively untested in terms of whether those accounts would creep on balance sheet in a crisis. An analogy to how they are treated is to remember back to the early days of the financial crisis when the structured investment vehicles set up off of bank's balance sheet (the shadow banking system at its worst) to invest in mortgage-backed securities).

The way these SIVs worked is that a bank would set up an off-balance-sheet entity, which would issue asset-backed commercial paper (debt backed by collateral with a maturity of less than 270 days). The proceeds would be used to buy MBS, as well as other higher-yielding, long-term investments. The SIVs were engaged in maturity transformation (borrowing short-term and lending long-term), a typical role of banks, except that the SIVs were acting outside the banking regulations because they were off-balance sheet. The key for them to maintain their solvency was to keep a very high credit rating on their ABCP; any doubts about the assets backing the commercial paper could (and would) lead them to implode.

During the financial crisis, the fall in value of MBSs, CDOs and the rest of the mortgage-related alphabet soup led to concerns about the solvency of the SIVs and made it more difficult for them to roll over their commercial paper. Facing the prospects of the SIVs collapsing, the banks which sponsored them in most cases stepped in to provide financing when the market for commercial paper closed completely.

After that travel back through time, an Islamic financial institution that offered a restricted mudaraba or wakala may not be legally required (and may be specifically prohibited by the Shari'ah board from offering such a guarantee) to repay the entire principal amount of the off-balance sheet accounts as if it were a deposit, but may still face market pressure to treat all off-balance sheet items equally to the unrestricted investment accounts that reside on their balance sheets.

Just as the SIVs were their own separate entity, and the banks had no legal requirement to bail them out (they were supposed to be able to sell assets to meet any liquidity needs, but those markets had become distressed as well), an Islamic financial institution may also feel the need to bail out the restricted mudaraba and wakala deposit holders in order to maintain their reputation in the market (reputation specifically around their solvency). In finance, the loss of confidence can be a death knell, even if the institution is fundamentally solvent.

In the end, there is not necessarily a better way to handle the on-vs-off-balance sheet treatment than the AAOIFI rule does, so long as Islamic financial institutions offer sufficient disclosure (and investors read the disclosure) about off-balance sheet assets. With Arcapita in bankruptcy now, it would be tempting to look to that case for some precedent, but that is not likely since they had few deposits, and what they did accept (which they said was more of a favor to investors in their deals, but which ended up becoming a significant source of funding for their portfolio companies) was unrestricted investment accounts, which would have been treated as an on-balance sheet investment account under the new AAOIFI standard.

Unfortunately, the other cases of financial distress among Islamic financial institutions since the crisis probably have not been required to make as many disclosures about the resolution of their financial distress, mostly because a lot have stumbled on in shadows of their former selves with their investors agreeing to "extend-and-pretend". Others have been folded into other banks and have not unfolded in public view.

SUNDAY
(Apr. 8)

Islamic finance should support greater diligence of offshore companies

It would be a welcome development if Islamic finance were to take the lead on a contemporary financial issue, rather than just wait for new developments to sprout up and then find ways to benefit. The Economist this week described the profitable business of registering companies in offshore locations (and some surprising onshore locations as well), based on a World Bank study released in late 2011 [pdf] that focused on the potential for these companies to facilitate money laundering because they are not required to undertake the level of diligence required by banks and other financial institutions.

Most of the structures that use the companies and other corporate entities detailed in the report have legitimate economic uses (for example the SPVs used in sukuk transactions), but many of them can also be used in money laundering by corrupt government officials, for example. At issue in the report is the flimsy diligence required by the service companies who help set up the companies and get them bank accounts. There is little that can be done by the Islamic banking industry in this regard, at least directly, since they are already subject to much more stringent anti-money laundering (AML) laws.

However, as a growing segment of the financial industry, and one which is frequently subject to the false accusation that it facilitates money laundering and financing of terrorism, it could benefit the industry if it were to advocate for strengthening the requirements by these service companies to perform additional due diligence on the companies they set up, including the SPVs that are used to facilitate sukuk issuance.

There would be some cost if the additional requirements were placed on the service companies (who would undoubtedly pass the cost on to their clients), but it would likely be minimal for the end users since the costs associated with the SPVs are de minimis compared to the transaction sizes involved in most sukuk.

The benefits, however, would be much greater. It would show that the Islamic financial industry is not only committed to applying the current AML laws, but that it is interested in encouraging greater disclosure in financial transactions and curbing avenues for money stolen through corruption and money destined to fund illegal activity to move around undetected. Islamic financial institutions expend considerable efforts to make commercial activity work in a way that is fair to both parties through disclosure, risk sharing and by limiting transactions where one party gains at the other's expense.

Encouraging the world to take relatively modest steps against money laundering, especially when a lot of the money involved is proceeds from corruption, would be a good way to offer evidence that Islamic finance is not just about replicating the conventional financial industry's products, but wants to take the lead in creating a more just world.