Role of Sukuk in Development Finance

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Role of Sukuk in Development Finance

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Presentation Outline

- Introduction
- Development Challenges in Muslim Majority Countries
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Introduction

The financial crisis of 2007-2009 and ongoing sovereign debt crisis in Europe has created a lot of questions and taught a lot of lessons.

Some contributing factors for the crisis include:

- Massive levels of debt.
- Consumption beyond means.
- Speedy financial innovation with lax regulations.
Introduction

- In the US, the share of total corporate profits generated in the financial sector grew from 10% in the early 1980s to 40% in 2006.

- These earnings are transaction costs for the productive sector.

- Financial institutions that were just supposed to be playing a supportive role to the productive economy got much bigger and unregulated through shadow banking practices.
Introduction

Nevertheless, financial intermediation has a useful function to perform in efficiently matching savers and investors.

What is needed is a new paradigm that can:

- Put the focus back on productive enterprise.
- Bring economic recovery with job creation.
- Limit and regulate speculative financial instruments.
- Improve corporate governance by influencing the incentives.
Introduction

- The two most important problems identified in a post-financial crisis look back are:
  - Perverse incentives.
  - De-linking of financial sector with real sector.

- IF principles connect all financial products with real assets.

- The Islamic finance industry has demonstrated its potential with steady 15-20% growth during the last two decades.
Introduction

- During the last decade and half, IF industry has seen tremendous growth even when the conventional financial institutions went into a deep crisis.

- Not only Muslim majority countries, but non-Muslim majority countries are also taking interest in using IF instruments to finance government projects.

- In recent years, UK, Luxembourg, South Africa and Hong Kong issued Shari’ah compliant securities.
Introduction

- However, despite the stellar growth, IF has a long way to go to fulfill its promise for a financial system that is:
  - Egalitarian.
  - Inclusive.
  - Meaningfully participative on both A&L side operations.
  - Active contributor towards distributive equity.
Development Challenges in Muslim World

- More than a billion people live in poverty even in 21st century.

- Most of the Muslim majority countries are generally poorer than the other countries on average.

- Most of the poverty resides in Africa and Asia and bulk of the Muslim majority countries are located in these continents.

- Half of the global poverty resides in the Muslim world while the Muslim population is 24% of the total global population.
According to SDPI, in Pakistan, as many as 58.7 million people are living in multidimensional poverty:

- 46% of the rural population.
- 18% of the urban population.

Other Muslim majority countries also face severe poverty:

- Bangladesh 43%
- Nigeria 62%.
Development Challenges in Muslim World

- Muslim countries require both:
  - Decline in poverty
  - Egalitarian distribution of income.

- These dual objectives require an inclusive financial system.

- Due to widespread poverty and weak governments, most of the Muslim majority countries are behind in spending on schooling and health services.

- Hence, the level of human capital, productivity and national income remain at lower levels.
Adjusting for income, if we take health expenditure as percent of GDP, Muslim countries had on average lower value as compared to the high income and middle income countries.
Nurses (Per 1,000 People)

- High Income: 9
- Middle Income: 4
- Muslim Countries: 2
Average income per capita multiple is 4 to 1 between high income countries and Muslim countries; whereas, carbon emissions multiple is 2 to 1.

It means that adjusted for income, Muslim countries emit more carbon for each additional income per capita that they earn.
Development Challenges in Muslim World

- In Middle east, there is immense potential to use solar energy alongside oil.

- In Arab world, the annual per capita share in water resource will be less than 500 cubic meters (<10% of global average).

- Lack of financing is one of the major obstacles for minimal use of renewable energy in developing countries.

- Financial sectors of developing countries are often underdeveloped and are unable to efficiently channel loans to produce renewable energy.
Development Challenges in Muslim World

- Developing countries spend about $1 trillion a year on infrastructure (Source: World Bank).

- As per World Bank, an additional $1-1.5 trillion will be needed through 2020 in areas such as:
  - Water projects like dams, desalination plants etc.
  - Power projects.
  - Transportation projects.
Development Challenges in Muslim World

- ADB estimates that emerging Asian economies alone will require $8 trillion over the next decade to satisfy growing demand in the areas of energy, water and transportation.

- WB figures suggest that only about 50% of the infrastructure demands are being met annually across emerging countries.

- In most developing countries, the governments pay more than 50% of their tax revenues in servicing debt and spend very little in development.
<table>
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<tr>
<th>Country</th>
<th>Debt Service (% of GNI)</th>
<th>PGI-GDP ($2.00) (%)</th>
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<td>Tunisia</td>
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</table>
Development Challenges in Muslim World

- Often, these governments trim development spending to cover other non-discretionary current expenditures.

- Provision of public infrastructure is circularly related to investment, tax base and tax collection.

- Chain Reaction
  - Improvement in public infrastructure.
    - Investment in the economy.
      - Increase in tax base collection and public goods.
      - Increase in employment creation.
Development Challenges in Muslim World

- Increase in tax base can boost the government’s capacity to service sovereign Sukuk effectively.

- This can also help in reducing:
  - Urban congestion.
  - Reduce prices of real estate.
  - Widen the geographic boundaries of urban centres.
  - Generate employment in new urban centres.
  - Facilitate closer migration to wide choice of urban centres.
  - Create new growth nodes and production zones.
Development Challenges in Muslim World

- In this scenario, IF has a lot of opportunity to showcase its potential in diverse areas of finance.

- IF is expected to deliver on its promise of egalitarian and inclusive financial system and with a potential to contribute in sustainable development.

- However, IFIs have largely not tapped and contributed in socially important segments like Microfinance.

- Globally, only 1% of IFIs assets are engaged in Microfinance.
Development Challenges in Muslim World

- MF itself has been unable to end poverty. E.g. Bangladesh.

- Income poverty is only one dimension of poverty.

- Need complementary investments in health and education.

- Need public infrastructure investment to boost business investment and create jobs.

- These projects in turn require huge start-up cost and long gestation periods as in the case of energy infrastructure.
Role of Sukuk in Development Finance

- Many Islamic banks do not have big enough balance sheets to issue large Sukuk with distant maturity dates.

- Bank financing for long-term infrastructure projects has become much less attractive under the new Basel III rules.

- In this regard, issuance of long-term debt securities can be a more useful way of financing.

- Sukuk are ideally suited to serve large-scale project financing needs.
Role of Sukuk in Development Finance

- Sukuk is an alternative Islamic finance instrument for conventional bonds.

- Sukuk is a certificate that represents ownership in underlying real asset(s).

- Islamic law does not permit interest and hence conventional coupon paying bonds are impermissible as per Islamic law.

- However, Islamic law allows sale and lease of real assets and the resulting income in the form of profit on sale or rental income stream on lease of assets.
Role of Sukuk in Development Finance

- Holders of Sukuk share in the lease or profit income generated from the ownership of real assets that the Sukuk certificate represents.

- Globally, the investors are increasingly demanding socially responsible investment (SRI) opportunities E.g. Green bonds.

- A green bond ties the bond issuance proceeds to environmentally friendly investments.

- Green bonds is a growing industry and the US$34 billion issued in 2014 is triple the amount issued in 2013.
Role of Sukuk in Development Finance

- It is expected that the issuance of green bonds may exceed US$100 billion by end-2015.

- Green Sukuk has the potential to become integral to financing the region’s ambitious renewable energy and infrastructure projects.

- It could help mobilize essential finance needed to fund the rising number of clean energy initiatives throughout the GCC.
Role of Sukuk in Development Finance

- By issuing sovereign Sukuk to scale up infrastructure investment, the governments can attract FDI.

- Projects to build toll ways, railways or even schools and hospitals, which generate revenues from tangible assets, are consistent with the Islamic finance rules of creating economic value.

- Large scale investment and long gestation period in these projects make Sukuk an appropriate way of financing.
Role of Sukuk in Development Finance

Some of the potential projects that can be financed using Sukuk include:

- Low cost public transportation.
- Solar parks.
- Wind farms.
- Dams.
- Water desalination plants.
- Dry and Sea Ports.
- Highways etc.
Challenges for Growth of Sukuk in DF

- Currently, differences of opinions among Shari’ah scholars can occur even within a single jurisdiction.

- Some years back, a respected scholar commented that as much as 80% of the Sukuk do not fulfill Shari’ah compliance criteria.

- Some scholars opine that allowing Bai Inah makes every conventional product convertible into an Islamic alternative.
Challenges for Growth of Sukuk in DF

- There is need for standardization and issuance of more commonly accepted structures to go on global scale like:
  - Ijarah.
  - Istisna.
  - Musharakah.

- **Tax Issues**: Many Sukuk also involve multiple transfers of an asset, which can make underlying assets subject to repeated instances of taxation.

- Debt financing of infrastructure projects will require considerable marketing effort.
Challenges for Growth of Sukuk in DF

- The current weak oil price may change the servicing capacity of the oil-rich governments and change their Sukuk ratings.

- Geopolitical crisis in Middle East may also affect ratings of sovereign Sukuk.

- MYR in which most Sukuk are denominated has undergone steep depreciation. This increases the currency risk and hence premium on MYR denominated Sukuk if the trend persists.

- One of the solutions could be a multi-currency Sukuk, but it comes at a higher cost of hedging.
Challenges for Growth of Sukuk in DF

- If the payoffs of Sukuk are entirely linked with economic asset returns rather than price differentials and rentals, then liquidity or even default risk may arise.

- Long gestation periods and public good nature of such projects will make it hard to link the Sukuk payoff with economic asset returns.
Analysis of Future Outlook

- All sovereign Sukuk issued thus far are for infrastructure assets but are not necessarily used for infrastructure projects.

- For any investor who wants to ensure that the funds raised for infrastructure projects are actually used for such projects, it is important that an appropriate structure is used for the chosen Sukuk.

- Musharakah based Sukuk and those based on the principle of Istisna may in fact ensure that the investors have real exposure to the underlying infrastructure project.
Analysis of Future Outlook

- More Sukuk issuance can increase the investment choices for Islamic banks and also enable them to have a wider market of firms looking for expansionary investment in long term fixed assets.

- Sovereign Ijarah Sukuk issued by the governments have been structured in such a way that it allows the government to mobilize funds.

- The Sukuk holders are also able to earn Shari’ah compliant income. It also facilitates Islamic banks to manage their liquidity as well as meet statutory liquidity requirement stipulated by the central banks.
Analysis of Future Outlook

- Through issuance of more Sukuk, the investment class assets universe will expand and it will enable the Islamic-conscious individual and institutional investors to effectively diversify their portfolios.

- Treasuries of Islamic banks will also have an expanded set of investment avenues.

- It will increase liquidity of these Sukuk and generate wider interest among all investors in the economy to consider investing in these investment vehicles.
Analysis of Future Outlook

- Islamic banks face liquidity risk in countries where Commodity Murabaha is not practiced.

- The surplus liquidity can be used by the governments by issuing sovereign Sukuk.

- This will enable the government to avoid crowding out by using excess liquidity already available with Islamic banks.
Analysis of Future Outlook

- In some jurisdictions, there are fiscal responsibility acts to contain public debt.

- For instance, in Pakistan, the fiscal responsibility act sets a limit of 60% for debt to GDP ratio.

- Such limits shall be revised to accommodate real asset backed infrastructure financing from Sukuk.
Analysis of Future Outlook

ADB is committing to provide:
  - Technical assistance
  - Credit guarantees.

Recently, the G20 group of nations' decision to examine the use of Sukuk to finance infrastructure investment could eventually spur a big increase in the size of the market.

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Recommendations

- However, more needs to be done on the regulatory framework and to engage DFIs to promote Sukuk based development finance in place of conventional fixed term loans.

- It can be explored to have DFIs acting as servicing agents and guarantors for infrastructure projects to establish trust and confidence of investors.

- Conventional bond conversion into Sukuk is also an area to explore since most governments already have high debt to GDP ratio.
Recommendations

- Long term Sukuk can be issued to establish socially important institutions like Microfinance to provide seed capital for establishing these institutions on the basis of Musharakah Mutanaqisa.

- Convertible Sukuk can also be offered to provide seed capital for socially conducive projects and then repackaging them as equity once these projects mature and become less risky.
Recommendations

- It is estimated that energy deficit eats up 1% to 2% of potential GDP in countries like Pakistan, India and Afghanistan.

- Hence, Sukuk in energy infrastructure can enable the Islamic financial institutions to contribute directly in economic growth and sustainable development.

- Likewise, there is abundant potential to help finance health and education infrastructure to create immense improvement in human capital.
For any Questions and Feedback, feel free to contact:

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