The Jinn of Sukuk

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Sukuk, whether one likes it or not, has been the flag bearer of the Islamic finance industry and it has had a talismanic role in its growth and expansion. Major conferences, entire industry reports and multiple awards have been devoted to this particular sector. Governments and institutions from across the globe almost exclusively contemplate their entry into Islamic finance through the issuance of so-called ‘Islamic bonds’. New Islamic finance institutions more often than not have a sukuk issuance at the very top of their business plans, whereas established IFIs have recently devoted time and effort in launching sukuk funds to broaden their appeal from an institutional to a retail audience. However, if real estate is all about location, location, location it seems that Islamic finance has been simplified into sukuk, sukuk, sukuk. The structure (albeit there’s more than a dozen permutations) has been demonized as the poison pill of the industry, so we must ask is this the case of a jinn amongst us? We can certainly choose to brand it as an evil spirit but much harder it is to scrutinize Nakheel for what might be in store for the industry. We foresee the following trends:

Structural Reform:
Sukuk has exemplified one of the key areas of discontent for industry participants. Specifically, it has exhibited many shortcomings in the way that some issuances have been structured - this has been primarily due to the predilection and popularization of structures that are essentially asset-based debt products rather than an asset-backed hybrid instruments. Yet Nakheel has arrived at a point in time when various Scholars, industry bodies and practitioners at large have repeatedly voiced their concerns over the former debt-like structures. Nevertheless, these calls have been fragmented and uncoordinated - making it unlikely that any realistic change would be enacted. This will see itself accelerated, with the latest events giving stronger support to the calls for industry reform (at least in the area of product structuring) although even without any official reform the shift away from certain types of issuance (such as murabaha sukuk) is already underway. There might be further implications beyond sukuk, as there would be spillover consequences onto other instruments or practices. Whether change is proactive or reactive is besides the point, as there will be change nonetheless.

Allocator Mindset:
What begs a question is whether allocation has been overly influenced by a preference for certain types of returns (i.e. correlated to interest rates). If sukuk aims to establish itself as a distinct asset class (as it has been suggested at conferences and forums) then it will require an equally distinct risk management framework and identify its proper place vis-a-vis other asset classes in a portfolio. Allocation decisions would have to be optimized in terms of sukuk, equities, commodities, alternatives, and so on. What is far from certain is whether Islamic banks are ready to overhaul their approach to allocation - this would require a monumental shift. A detachment would be required – by this we mean a financial, structural and philosophical one - since the economics of sukuk needs to move away from interest-based returns (regardless of who originates or underwrites such products). This shift is required from scholars and structuring teams but crucially it has to be driven by investors at large. The usual over-subscription to new sukuk issuance is evidence of their tacit approval of current business practice and in this respect the signs are not positive. Every single type of service provider will have something to say about sukuk, but the actual allocators are mute in this respect. They are the ones that can drive the necessary change - but are they willing to do so?
Editor’s Note

Sector Diversification:
This is another area ripe for improvement – we have covered this aspect extensively as it pertains to Islamic investment funds (where we have identified various issues such as a distinct geographical bias as well as multiple gaps in terms of asset classes). It is not surprising this is the case for sukuk as well, where underlying assets have been focused on specific regions (say GCC) and sectors (say real estate). Then again, there is absolutely nothing wrong with GCC exposure nor real estate exposure, except that such an exposure should be part of an overall diversified portfolio - not the exclusive component of one. Another strong distinction in the industry has been between Malaysian sukuk and GCC sukuk, with many Malaysian issuances deemed unacceptable to GCC scholars. It is rather ironic that the future is behind an issuance from the UAE, but one of the trends going forward will be a revisiting of how justified this distinction really is. Many IFIs have been actively investing in issues from their counterparts on the other side of the Indian Ocean, and while this has typically not been widely reported one will expect cross-border activity to be less of a taboo going forward.

Asset Origination:
A further line of inquiry relates to why products haven’t been developed for other regions/sectors? The un-elegant answer is sheer lack of origination expertise. This relates to the ability of Islamic banks to identify assets and opportunities away from their home markets, and the know-how to structure an issue in a timely and efficient manner in jurisdictions outside of their own. The concern here is that if Islamic banks have been immune to the global financial crisis they will be equally immune to market rallies and the anticipated recovery in the global economy (the simple fact that they are not present in a downward market does not validate their business model). Another outcome of Nakheel will be a stronger impetus to build collaborative efforts with non-IFIs that can provide this sector expertise and/or local know-how, so that IFIs move away from their comfort zones.

Asset Quality:
In the US, the default of East Cameron Gas sukuk has been highlighted as a positive development (the legal outcome has upheld the sukukholder’s claim to the underlying assets). What is less evident is that this was a highly-engineered issuance that many in the conventional world would not have touched with a stick. So we must ask whether Islamic finance is the dumping ground for suboptimal investments? While distressed or special situation strategies have their merits it seems the project pipeline of Islamic finance tends to attract rather unconventional offerings. The quality of the underlying assets has also been a highlight of Nakheel, and this has often been exemplified by the lack of rated sukuk and in that sense, sovereign sukuk has been highlighted as a pre-requisite for market development (having a rated issue that in turn provides a benchmark for pricing corporate sukuk). Issuers might have to reduce their reliance on government direction (or support) but most importantly the private sector will need to focus its attention on identifying a much broader set of quality assets.

We expect plenty more headlines relating to Nakheel, but the real story will be on how the industry responds - either it falls back in denial or it embraces this as an opportunity to reinvent itself. Oddly enough, a Jinn has the ability to appear in various forms (most references point to a snake or other animals), so a financial instrument is not entirely out of the question. Then again, these spirits are not exclusively evil and in fact are able to do as much good as they can do mischief. Most tellingly, the Jinn are said to have been created from fire (and Nakheel is certainly fanning the flames of discontent in the industry). Nevertheless, human beings are superior to Jinns, so it is not sukuk that should be demonized but instead the emphasis should be on the various stakeholders (scholars, IFIs, service providers, and - most crucially - investors) as they have the ultimate responsibility to purge these problems away.

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