



# EUROPEAN *SUKUK* ISSUE

A SURVEY INTO CHARACTERISTICS AND  
POTENTIAL DEMAND



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# Introduction

Over the past two decades Islamic finance has shown a 10 – 15% year on year growth and is becoming an integral part of the financial industry. Although still mainly focussed on the Middle East and Asia, it is now expanding beyond these markets into Europe and the United States. Bank of London and The Middle East plc has commissioned an MBA project with Said Business School, Oxford University<sup>1</sup> to identify the UK investor appetite for a European *sukuk* issue in terms of potential market size and preferred product characteristics. The report presented here contains an analysis of the data that has been gathered during the interview stage of 56 respondents who took part in the survey for this project in August 2009.

The report contains 4 sections. In section 1 a brief overview of the current *sukuk* market status is laid out. This is followed by an analysis of the main characteristics of a European *sukuk* in section 2 and an assessment of the potential UK demand in section 3. The final section offers a short summary and some concluding remarks.

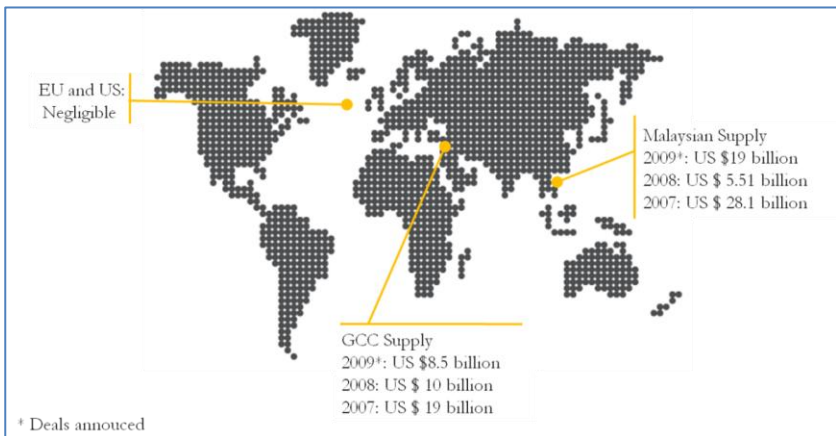
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<sup>1</sup> The interviews and initial analysis of the data has been executed by Elena Tereshonok, Rakesh Kariholoo, Hisham Refaat and Srihari Devatha of Said Business School, University of Oxford, alumni 2009.

## Current Status

*Sukuk* are often identified as Islamic bonds and are issued by governments and corporations in line with the stipulations of Sharia'a. The majority of *Sukuk* in issuance are asset backed and often structured as a sale and leaseback (*Ijara*) transaction which pays a periodic coupon using the rental income under the lease. One of the main distinguishing characteristics is that the *sukuk* certificates represent proportional ownership of the underlying asset. As a result, *sukuk* tend to be highly collateralised.

A recent report from Ernst & Young (E&Y)<sup>2</sup> shows that between 2007 and 2009 *sukuk* are still largely originated from Malaysia and the GCC. Issuance from other jurisdictions such as Indonesia is increasing, but at this point in time still negligible. Figure 1 below shows how the issuance compares geographically.



**Figure 1 - Global *Sukuk* Issuance 2007 – 2009 (source: E&Y (2009))**

<sup>2</sup> E&Y Islamic Funds and Investments Report 2009

A number of European governments have in recent years announced their plans to become the main hub for Islamic finance outside the Middle East and Asia. The UK is by far the most advanced in this and has made changes to the finance act and other regulatory framework in order to ensure a level playing field is created for Islamic financial institutions. The reasons for *sukuk* issuance outside the Middle East and Asia vary, but can be summarised for different issuers as follows:

### **Governments**

In consequence of continuing impact of global financial crisis, government borrowing requirements are rising and additional sources of liquidity need to be explored. In addition, there are political drivers such as inclusion of the Muslim population and maintenance of the status of “international financial centre”.

### **Corporate**

With conventional banks drastically reducing their corporate lending, corporations are looking for alternative sources of funding and are attracted to the liquidity in Islamic finance. In addition, they have a desire to be “seen to do the right thing” when it comes to cultural awareness and diversification of investor base.

The main disadvantage is that investors tend to be apprehensive when investing in new structures and require higher returns for a comparable level of risk to make up for this. The majority of

*Sukuk* therefore was historically issued at a wider spread than a comparable conventional bond issue.

Despite the downturn in the capital markets, the successful issue of London listed \$750m Government of Bahrain *sukuk* (reports suggest 4x oversubscribed) shows a healthy investor appetite for *sukuk*.

Due to legislation obstacles, no UK issuer has issued a publicly listed *sukuk* in London to date. However, the Finance Act 2009 has paved the way for issuance of Alternative Finance Bonds using sale and leaseback structure of real estate assets bringing the opportunity to issue a UK based *sukuk* structured on UK assets a step closer. To gauge the UK investors' reaction to such an opportunity, this report looks at the required structure and the potential appetite for a European *sukuk*, measured on the basis of primary data

collected via interviews with 54 market participants, of which 19 were academics, consultants and rating agencies. The remaining 35 respondents can be divided in 4 main categories as shown in figure 2.

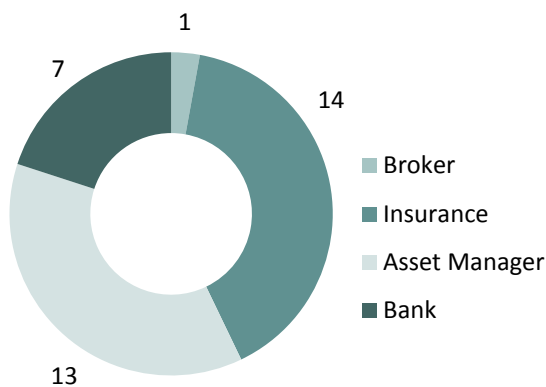


Figure 2: Categories of Respondent

The responses from these 35 respondents form the basis of the remainder of the analysis, where applicable complemented with any information from the other respondents.

In excess of 85% of respondents were aware of the existence of *sukuk* with over 50% of the respondents having previously invested in these instruments. The main reason for not investing in *sukuk* is associated with the lack of liquidity in the market in combination with the relatively small size of the issues and the short durations.

Those who have previously bought *sukuk* typically have a mandate to do so since they are Sharia'a compliant institutions or responded to client requirements. Others would consider investing in *sukuk* depending on the return, term and other characteristics.

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# Characteristics of a European Sukuk Issue

The respondents were asked to provide insight in the characteristics required for a *sukuk* to be an attractive investment opportunity. Price, maturity, currency, issuer and rating were amongst the issues addressed.

## Price

Out of the 35 respondents, just over a third specifies that in order to consider investing in *sukuk* it should be priced at a premium over conventional bonds. The reasons stated for this were mainly associated with the lack of liquidity, to cover additional legal cost and due to the higher cost involved for due diligence associated with the complexity and novelty of the instrument.

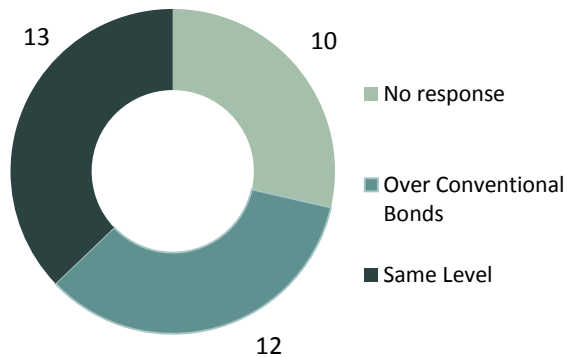


Figure 3: Pricing

Equally, around a third of the respondents expressed the opinion that *sukuk* should be priced at the same level to a conventional bond since they have similar characteristics and have the same risk level. Another ten participants did not provide a response to this question.

## Issuer

The preferred issuer is strongly dependent upon the investment mandate and varies per investor. A few main issuer characteristics surface:

- Investment grade credit quality of BBB or above
- Government or established corporate (i.e. existing presence in capital markets), the latter preferably backed by a government.

## Maturity

The current market norm for *sukuk* maturity is average five years, because most *sukuk* are issued to Asian and Middle Eastern investors who do

not have appetite for longer maturities. In addition, the relative short history of the instrument has an impact on the length of time an investor may require. European

investors tend to have a more sophisticated investment strategy and need a range of maturities – thus forming a yield curve – to meet their requirements. Out of the 35 respondents, 10 have indicated that they have no preference for any particular maturity.

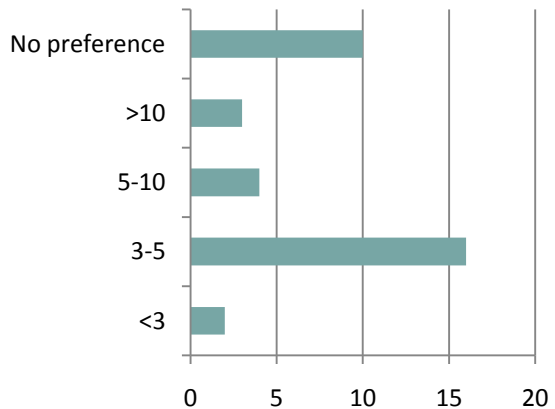


Figure 4: Maturity Preferences

The remaining 25 respondents had different maturity requirements, with the majority having a preference for maturities in the 3 – 5 year bands. Maturities up to 10 years and above are typically preferred by (life) insurance companies. Shorter maturities are typically preferred for liquidity reasons. One of the respondents indicated that a shorter maturity would be preferable due to the fact that rates are low in the current market and are likely to increase over time.

## Coupon frequency and type

The coupon frequency appears to be even more of a secondary nature than maturity.

In excess of 51% of the respondents express no preference at all. Another 14% are indifferent between quarterly and semi-annual coupons.

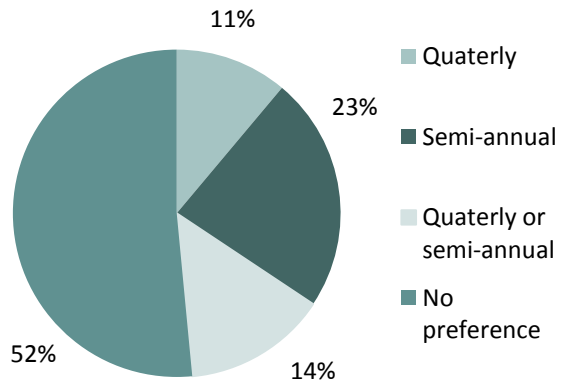


Figure 5: Coupon Frequency

Those respondents with a specific preference for coupon frequency, a semi-annual coupon is more attractive than a quarterly coupon.

The respondents were further asked whether they would have a particular preference for either fixed or floating coupon. The majority of respondents indicated that there should be a mix of both fixed and

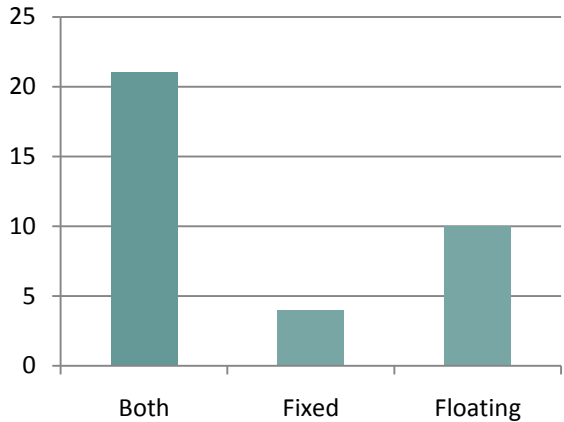


Figure 6: Fixed or Floating coupon

floating rate available. Those who have a specific preference for either of the rate types prefer a floating rate. The main justification for this is related to the fact that currently rates are low, which results in unattractive long term yields.

## Issue Size and Currency

The preferences for the size of the issue are slightly ambiguous with in excess of 51% of the respondents having no particular preference for a specific minimum size.

It is, however, important to note that even respondents with no preference for a particular issue size indicate that size influences liquidity in the market.

Slightly less than 30% indicates a preferred size of 200 million or over, with the vast majority preferring benchmark size (500 million or over). The main reasons cited are liquidity concerns for smaller issue sizes.

In excess of 65% of the respondents have no preference concerning the minimum denomination of a sukuk. Those who do express an interest in specific denominations typically do so as a result of internal requirements or because they operate in a retail market environment.

## Underlying Asset

Respondents typically have no particular preference for an underlying asset and would look at an individual issue to see how it fits in with their overall portfolio at the same time ensuring they do not incur any excessive concentration risk. Implicitly there is a strong sentiment towards diversified assets with strong cash flows and, in the current market, away from real estate. The quality of the asset can determine the degree of recourse or credit enhancement required in the structure to secure the investment grade rating demanded by the investors.

## Type of Issue, Listing and Rating

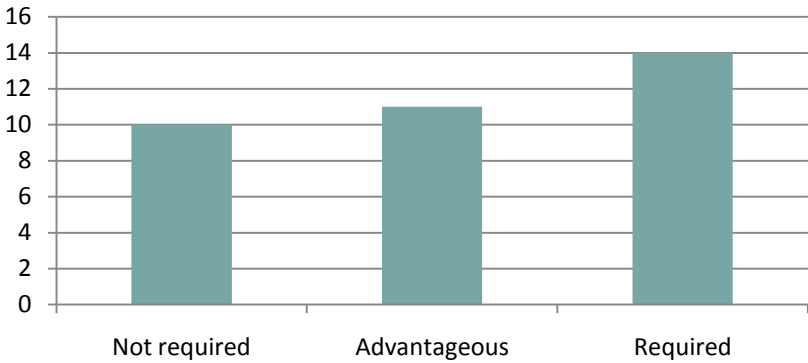
Given a choice, just under 50% of respondents prefers an issue to be structured like a Eurobond.

One respondent expressed a preference for a Collective Investment Scheme and in excess of 50% of the respondents did not provide any indication.

The majority of the respondents stated that a listing is required in order to enhance transparency and tradability of the issue. In addition, another 31% of the respondents perceived the presence of a listing to be advantageous for the same reasons although

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they do not deem it to be an absolute necessity. A total of 29% of the respondents does not require a listing for an issue to be considered for investment purposes.



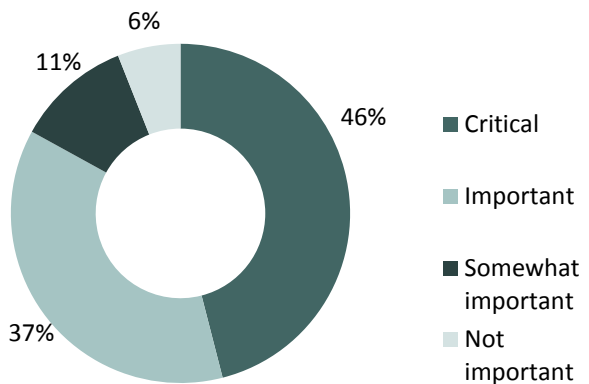
**Figure 7: Listing Requirement**

When considering whether to obtain a listing or not, it needs to be borne in mind that in order for an issue to qualify as an Alternative Financing Investment Bond in the UK, and to be exempt from withholding tax, a listing is required.

From an investor’s perspective, the rating is deemed to be more important as becomes clear from the responses to this question.

In excess of 80% of all respondents consider a rating to be important or even critical.

Further analysis of the responses shows however, that although significant



**Figure 8: Rating the issue**

importance is attached to a rating, the majority of the respondents supplement this with their own, in-house, analysis. The respondents that stated a rating is somewhat or even not important seem to rely more heavily on their own processes to determine the credit worthiness of the issue and the ability of the issuer to repay. Some respondents use the rating as their initial investment decision.

In summary, the preferred characteristics of a European *Sukuk* issue can be defined as follows:

Characteristic	Preference
<b>Price</b>	Similar to or higher than conventional bond
<b>Issuer</b>	Corporate or Government with credit quality BBB or above
<b>Maturity</b>	3 – 5 years
<b>Coupon</b>	Fixed and Floating No particular preference for periodicity
<b>Issue size</b>	500m or above
<b>Asset</b>	Diversified assets with strong cash flows
<b>Structure</b>	Eurobond
<b>Listed</b>	Yes
<b>Rated</b>	Yes

**Table 1** - Summarised *Sukuk* characteristics

# Potential Market Size for a UK Sukuk Issue

The exact potential size of the market is difficult to determine, mainly as a result of the fact that the instrument is still relatively new and the number of European listed issues is still fairly low. However, given the characteristics defined in the previous section, 69% of the investment

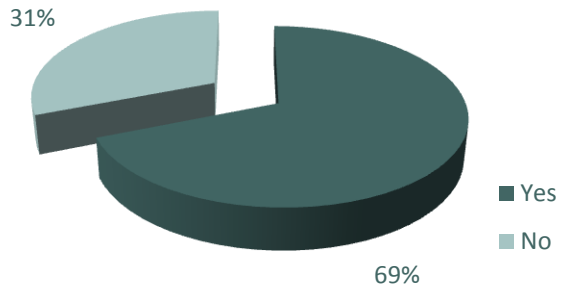


Figure 9: Respondents interested in Sukuk

professionals that have responded to the survey have indicated that they would consider investing in a European *Sukuk* issue.

**69% of Investment Professionals indicated that they would consider investing in a European Sukuk**

Like any other bond, the issue would have to fit within the overall portfolio and meet the investment requirements associated with, among others, issuer, credit quality and size. The total demand depends on the investor and is often associated with a percentage of the issue size or a percentage of their total holding. The fact that the market is still relatively young has an impact on the perceived risk levels and available liquidity which are in turn reasons to approach investing in a *Sukuk* with caution.

For those respondents with an interest in investing in *Sukuk*, the decision making process for a particular issue is relatively similar to the investment decisions made for any other investment opportunity.

Generally, there is more than one investment criteria that is applied in the decision making process. The criteria mentioned most by the respondents are yield, rating, issuer, asset and Sharia'a compliance. Other criteria such as liquidity, size and volatility are mentioned by a number of investment managers but do not appear the most important. It is worthwhile to note that liquidity is not often specifically mentioned in the decision making criteria. However, when queried further, only the insurance companies deem secondary market liquidity to be irrelevant. All other respondents attach differing degrees of importance to liquidity of the issue.

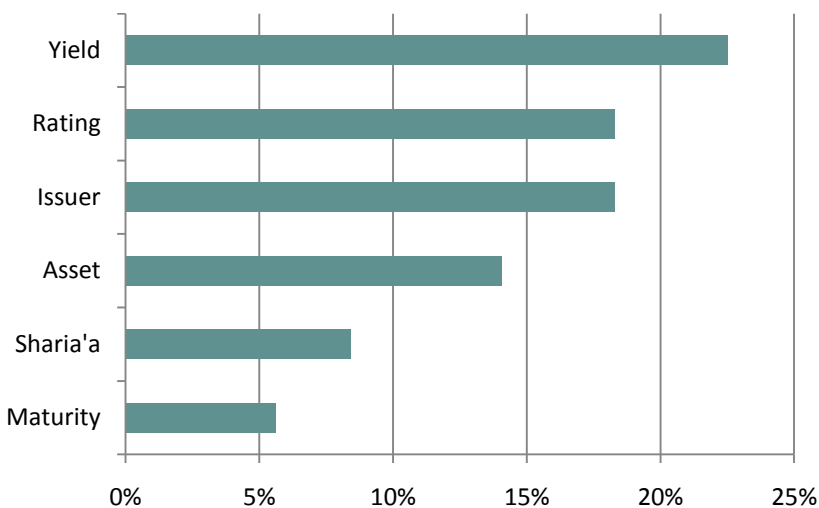


Figure 10 - Investment decision criteria

The underlying ethical principles appeared to be low on the priority list for most investors, and investing in *Sukuk* is generally not seen as either enhancing or reducing the risk in a portfolio. Querying some further characteristics of the issue learns that 22 out of 35 respondents find the reputation of the book manager or underwriter of importance.

However, although it appears that the strength of the book runner may influence the buying decision, it is generally not deemed to be of primary concern. Reputation and

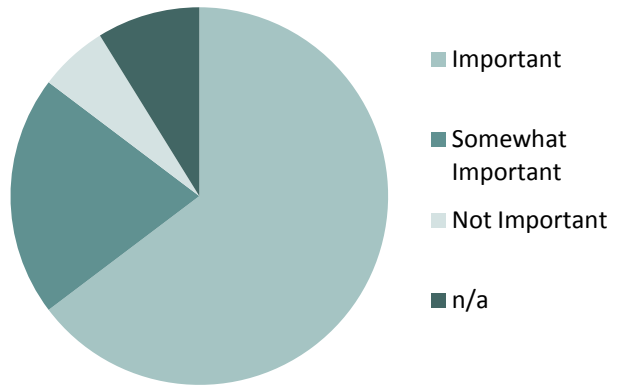


Figure 11: Reputation of bookrunner/ underwriter

size of the bank are often mentioned in combination with enhanced credibility of the issue and distribution capabilities.

The majority of respondents foresee that as the market develops, their demand for *Sukuk* might increase. There are a number of factors that will influence future demand including the general demand for fixed income paper, issuance of a Government *Sukuk*, growth and development of the market, and the growth of the Islamic insurance market.

## Concluding Remarks

This research started out to answer the question whether there is a potential demand in the UK for a European *Sukuk* issue. It turned out that there was no straight forward Yes or No answer to this. The potential demand is currently still difficult to assess due to the fact that the market is still relatively young and the total outstanding amount of *Sukuk* is small compared to the overall bond market. However, where a few years ago the majority of respondents would not have heard of *Sukuk*, we found that in excess of 85% of the respondents have heard about the instrument and in excess of 50% has invested in them.

It comes as no surprise that the preferred characteristics of a *Sukuk* issue summarised in table 2 below are largely similar to a UK investor appetite for bond issue in the conventional market.

Characteristic	Preference
<b>Price</b>	Similar to or higher than conventional bond
<b>Issuer</b>	Corporate or Government with credit quality BBB or above
<b>Maturity</b>	3 – 5 years
<b>Coupon</b>	Fixed and Floating No particular preference for periodicity
<b>Issue size</b>	500m or above
<b>Asset</b>	Diversified assets with strong cash flows
<b>Structure</b>	Eurobond
<b>Listed</b>	Yes
<b>Rated</b>	Yes

Table 2 - Summarised *Sukuk* characteristics

There are other characteristics that influence the investment decision such as the reputation of the book runner and liquidity in the secondary market. In order for an issue to succeed, there will almost certainly have to be a market maker. In itself this may pose an interesting challenge since Sharia'a prohibits short selling, and a market maker will have to provide both buy and sale prices regardless of whether he owns the underlying asset. Generally however, the vast majority of respondents view the issuance of a European *sukuk* positively, and will, given the right characteristics, certainly consider investing as long as the issue meets their investment criteria.

## About BLME

Bank of London and The Middle East plc ("BLME") is an independent UK wholesale Sharia'a compliant bank based in London. BLME received FSA authorisation in July 2007 and is the largest of its peers in Europe. It is led by a management team that brings together a combination of experienced international bankers and leading experts in Islamic finance.

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