



Sukuk in focus

The necessity for global common practices

Deloitte Islamic Finance Insights Series
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Foreword from Deloitte



Dr. Hatim El Tahir, FCIS
Director, Islamic Finance Group
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Dear Islamic finance practitioners,

For nearly two decades, many financial regulators and investment institutions around the world have been committed to strengthening practices in Islamic capital markets, and leverage standards for Sukuk as a key investment asset class. Embedded within this has been an equally strong commitment from industry standards setters and other business supporting institutions (BSIs) to address practice differences and inconsistency.

It is with great pleasure that we produce this report, and put forward our thoughts on a number of business practices relevant to the Sukuk markets development in Asia, the Middle East and Europe.

The themes, topics and practice reviews and analysis of selected key markets have been researched in collaboration with ISRA, leveraging our specialist skills and sector expertise, engaging leading industry institutions and prominent thought leaders to reflect on these challenges and opportunities.

One driving theme is the global discussion around impact investment and responsible finance triggered by several industry initiatives. The extent of adopting these investment guidelines by Islamic finance need is to be assessed and aligned to global capital markets, leveraging on Sukuk as a catalyst for investment projects in several economies.

For Islamic finance practitioners, this will require re-thinking and re-modelling of their governance frameworks and business operating channels. Most importantly, practitioners need to harness their Islamic finance corporate culture and embrace a 'back to basics' approach and adhere to designing products and services in line with the 'equity-base' differentiator to fund real economy projects.

Clearly, this can be streamlined in the first place, with Maqasid Al Shariah, which reflects values and practices of social and economic inclusion and sustainable community development. Needless to say, this goal can be achieved more efficiently by adopting, for instance, the United Nations' (UN) Sustainable Development Goals (SDGs), the Principles of Responsible Investment (PRIs), and social impact and green Sukuk, to name a few.

This report is produced under the Deloitte Islamic finance series "Leading by Engaging", produced by the Deloitte Middle East (ME) Islamic Finance Knowledge Center (IFKC).

We hope that you enjoy reading it and do not hesitate to get in touch should you need any more information.

Foreword from ISRA



Professor Mohamad Akram Laldin
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For a Sukuk market to thrive, a conducive environment that would support active Sukuk issuance, promote corporate governance, ensure fair, transparent and efficient markets, and safeguard investor protection is vital. These principles are in line with international best practices promoted by capital market standard-setting bodies such as IOSCO. As core Sukuk markets move towards aligning their practices to these international standards—usually adopted by leading financial centers—Sukuk will gain firmer ground in attracting the wealth of global investors.

The adoption of best practices will also go a long way in boosting market confidence and thus eliminating trust deficit issues, especially after the recent disputes in some Sukuk issues. Indeed, these disputes have further highlighted the need for the institutionalization of a proper Shariah governance framework to ensure end-to-end compliance of Sukuk to the Shariah principles starting from the structuring stage until the time of redemption.

The setting up of international Islamic standard-setting bodies such as the IFSB, AAOIFI and IIFM has to some extent promoted greater harmonization in terms of regulation and supervision, Shariah standards, and standardization of Islamic financial products and contracts, respectively. However, given adoption of these standards is only voluntary, thus far they have been adopted by a few jurisdictions.

Besides, more efforts are required in the aspect of standardization of legal documentation for various Sukuk structures. This standardization will help in providing simplified documents, which will lower Sukuk issuance costs—a key factor pushing issuers and investors towards conventional bonds. There is a 'Sukuk standardization' standard (IIFM Standard 12) currently being envisaged by IIFM. This will certainly prove beneficial for Sukuk to gain further traction.

This report, developed with the collaboration between ISRA and Deloitte ME, is an attempt at highlighting the necessity for the adoption of global common practices in Sukuk markets. I hope the content will be beneficial to all stakeholders of the Islamic finance industry.

I would like to seize this opportunity to thank all those who provided support to produce this report. Special thanks go to the team at Deloitte Middle East and ISRA for their hard work and efforts.

Last but not least, I would like to show appreciation to the subject matter experts and industry practitioners of the two workshops held in Kuala Lumpur and Bahrain as well as the respondents of the online survey who shared their ideas and thoughts on the practices of Sukuk markets.

To all readers, I wish them an insightful and rewarding read.

Acknowledgments

Deloitte Middle East and ISRA are grateful to acknowledge the support of a number of institutions and their contributions towards the making of this report. We salute their courage and spirit to work with us in addressing industry issues, which we aim to share with all industry stakeholders worldwide.

A special word of thanks and appreciation is due to three individuals who have tirelessly continued to support 'Deloitte Sukuk market dialogue' and generously provided time for our events and conferences, despite their busy work schedules.

- Stella Cox, CBE, Managing Director, DDCAP Group
- Tallat Hussain, Environmental Counsel, White & Case
- Peter Casey, Advisor to the IFSB and the UAE Securities and Commodities Authority (SCA)

While the report has benefited greatly from their contributions, the views expressed herein are solely those of the authors and do not necessarily reflect the views of Deloitte and ISRA.

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- Stuart Hutton, CIO, Simply Ethical
- Mufti Hassaan Kaleem, Shariah Scholar

Industry supporters



Executive summary

This report discusses the drive to promote efforts to enhance the functionality of Islamic capital markets amidst the increasingly fragmented Islamic financial marketplace. In doing so, we believe, the Sukuk market ought to have better common practices globally as a prerequisite for building effective Islamic capital markets.

We structured our analysis around three broad considerations: the element of enhancing Shariah governance with noble objectives of the Shariah linked to those of the global sustainable goals, the strategic role of industry institutions to harness good practices, and current regulatory and policy support initiatives in key markets selected for this study.

In our view, this approach will not only help enhance the functionality of Islamic capital markets but also integrate Sukuk practices more effectively with global investment and financial markets.

To reflect on global investment practices, we have invited industry experts to share their perspectives on processes and principles of sustainable investment that will harness the case for global common practice of the Sukuk markets.

- Dr. Hurriyah El Islamy provides an overview on the development of regulatory capabilities in Indonesia, emphasizing the government policy support and opportunities presented by several new initiatives and issuances.
- Mufti Hassaan Kaleem describes the Sukuk market landscape in Pakistan and discusses the different government measures taken to create an enabling environment for Islamic finance and Sukuk in funding some current projects. He also introduces the possible development and introduction of Shariah-compliant alternatives for T-Bills, using the Pakistan Mercantile Exchange Commodity Trading Platform.



Shariah governance and sustainability



Practice and market institutions



Regulatory capabilities and market development



Thinking further ahead: Practice & policy considerations

- Daud Vicary Abdullah continues the industry analysis and practice in the UK and Luxembourg. He highlights the extent of development and depth of experience, particularly in the aspects of business, legal, tax and Shariah issues. His chronological analysis did not include the evolution of Islamic finance, government support policies, recent initiatives and challenges presented by the rise of Fintech, the Brexit impact, and green finance.
- Khalid Howladar offers a critical analysis on regulatory support needed to drive Sukuk standards, which he arguably views as being key to boosting growth and liquidity. He concludes with a note of advice that “the best way to move forward is to empower investors through transparency, governance and education”.

Shariah governance

Maqasid Al Shariah & sustainability

Priority sectors & SDGs alignment

Sukuk structures & investors preference

Practice & Shariah challenges

Development by standard-setting bodies

Asia

- Malaysia
- Indonesia
- Pakistan

Middle East

- GCC countries

Europe

- United Kingdom
- Luxembourg
- Turkey

Regulatory support

Niche, specialized Sukuk

Serving priority sectors

- Stuart Hutton continues with the analysis and offers complementary views on the value proposition of developing an alternative Sukuk marketplace, featuring responsible investment and structures that are emphasizing on delivery of transparent flow of funds for positive green and social return.

However, for most of the analysis, we emphasize on the importance of aligning Maqasid Al Shariah in developing a new governance and practice framework that is able to accommodate emerging principles of responsible investment, green finance and sustainable development goals.

Research framework & methodology

We have structured our industry report against three functions of Sukuk market development and twelve clusters of practice considerations, as illustrated in the diagram on the right.

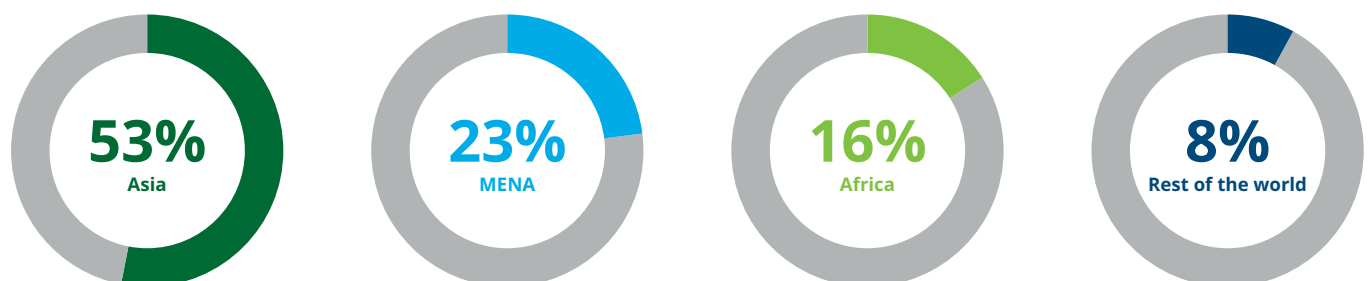
To achieve our set goals and objectives, we followed a maturity assessment approach, supported with a series of industry discussions and engagement processes to examine the above functions and clusters of practical issues and ensure a wide participation of practitioners and policy makers in the key markets identified.

Following this assessment, Deloitte and ISRA identified the main elements of practices in the Sukuk markets and designed a set of questions for practitioners to address. First, we organized two stakeholder workshops at two international industry hubs with 70+ total participants including industry leaders, subject matter experts and regulators. The prime objective was to engage practitioners, investment bankers, regulators and scholars in a focused dialogue. Workshop one was facilitated in Kuala Lumpur, Malaysia and workshop two in Manama, the Kingdom of Bahrain.

Secondly, we launched an online survey in the Summer of 2017 to obtain stakeholders' perspective and gain further insight. Participants included industry professionals such as regulators, policy makers, Shariah scholars, compliance managers and other knowledgeable industry leaders. Figure 1 illustrates the breakdown of geographical participation.



Figure 1: Participating respondents by geography



Introduction: Strategic practice approach

Rapidly advancing technologies, increasing socioeconomic pressures, and infrastructure investments are opening doors to disruptive innovation in Islamic capital markets. It has been nearly two decades since the first Sukuk on the global finance scene, yet it remains popular. However, corporates have been slow to tap into this niche market and investment bankers equally have been short to innovate Islamic debt capital market instruments which are simple (i.e. not overly complex structures with enforceability uncertainty) and have grown in size, at 19.5% as of 2017, of total global assets (IFSB's Financial Stability Report, 2018).

The drive to formulate global common practices for Sukuk and the wider Islamic capital market will require stakeholder collaboration to align regulatory and associated standards and practices. Furthermore, industry growth is evidently facing performance headwinds as a result of macroeconomic conditions in several markets around the world. As a result, the Sukuk market landscape looks set to become increasingly divergent and segmented. Hence, it may be time to take a closer look at how Sukuk, being already somewhat internationally accepted and tested, may continue to spur growth in local economies, through practice convergence to reduce issuance frictions.

To achieve this challenging goal, it may be effective to consider the streamlining of Sukuk issuance practices with international investment guidelines already in place. To assess how this proposition can be achieved, and support its merit, the following discussion will address the core elements of the global common practices in Sukuk markets. Such an approach will not only help enhance the commercial competitiveness of Sukuk as an international investment asset but also transform the way its market integrates with the global capital marketplace and serves the social and economic needs of Muslim societies.

This practice improvement approach on operations, reporting and investment considerations, in our view, potentially strengthens Sukuk market efficiency, increasing its viability and impact on Muslim economies and attracting international investor demand. Three core elements have been addressed in the following sections:

- Shariah governance and sustainability
- Practice and market institutions
- Regulatory capabilities and market development

It may be time to take a closer look at how Sukuk, being already somewhat internationally accepted and tested, may continue to spur growth in local economies, through practice convergence to reduce issuance frictions.

Shariah governance and sustainability

Setting the context for priority sectors

It is widely acknowledged that the primary objective of Islamic law is the realization of its benefit to mankind by preserving and protecting five fundamental objectives of Shariah (Maqasid Al Shariah): religion (Deen), life (Nafs), lineage (Nasl), intellect (Aql) and property/wealth (Mal).

The ultimate objective of Shariah is to protect the well-being of people and nature, which lies in the safeguarding of these five fundamental objectives (refer to Table 1) through the promotion of social justice. These objectives have great resemblance to the United Nations' Sustainable Development Goals (SDGs)

and should be reflected in investment objectives, proceeds, structure Sukuk issue. These fundamental objectives have translated into contemporary social needs i.e. 'social priority sectors', addressing the socioeconomic needs of the Muslim-majority economies or the economies of the Organization of Islamic Cooperation (OIC).

Recent developments in international investment shows that both issuers and investors are keen and supportive of adopting the global sustainable and responsible investment (SRI) principles developed by several initiatives. One important aspect of making Sukuk more attractive to these investors is to adapt

these investment guidelines within its structure.

While a reasonably large number of conventional bonds have adopted these sustainable and green initiatives, we have recently seen growing interest in green Sukuk and industry institutions adopting these global SRI principles.

This trend, in our view, can potentially accelerate Sukuk issuances and broaden the investor-base globally. Key to this is designing strategies within priority sectors and blending the types of SDGs and other investment practices and standards as shown in Table 1 below.

Table 1: The priority sectors: Maqasid Al Shariah alignment to Sustainable Development Goals (SDGs)

Maqasid Al Shariah	Property (Mal)	Intellect (Aql)	Life (Nafs)	Religion (Deen)	Family/Lineage (Nasl)
Priority sectors	Infrastructure	Education	Housing and food security	Sustainable environment and energy resources	Healthcare
Sustainable Development Goals (SDGs)	<div>8 DECENT WORK AND ECONOMIC GROWTH</div> <div>9 INDUSTRY, INNOVATION AND INFRASTRUCTURE</div> <div>17 PARTNERSHIPS FOR THE GOALS</div> <div>11 SUSTAINABLE CITIES AND COMMUNITIES</div>	<div>4 QUALITY EDUCATION</div>	<div>1 NO POVERTY</div> <div>2 ZERO HUNGER</div> <div>3 GOOD HEALTH AND WELL-BEING</div> <div>6 CLEAN WATER AND SANITATION</div> <div>10 REDUCED INEQUALITIES</div>	<div>7 AFFORDABLE AND CLEAN ENERGY</div> <div>12 RESPONSIBLE CONSUMPTION AND PRODUCTION</div> <div>13 CLIMATE ACTION</div> <div>14 LIFE BELOW WATER</div> <div>15 LIFE ON LAND</div> <div>16 PEACE, JUSTICE AND STRONG INSTITUTIONS</div>	<div>3 GOOD HEALTH AND WELL-BEING</div>

Source: Deloitte Research and Analysis

Responsible investment and Islamic finance

The increasing discussion over the concept of responsible investment has attracted wider attention amongst investors globally. Clearly, Islamic finance has some resemblances as well as differences and Table 2 lists these differences. Nevertheless, Islamic investment practitioners have debated the need for alignment between both to articulate globally accepted investment products.

However, responsible investment have been featured with three key differentiating points as follows:

- Strong emphasis on aligning finance with social good.
- Seek to increase the contribution of the finance sector to the real economy.
- Pursue a more resilient financial system void of unsustainable system risk.

Back to basics and the rationale for common practices

The trend towards common global practices for Sukuk poses two types of challenges to Islamic finance:

- **Strategic governance framework:** Development of a new Shariah-based approach aimed towards improving governance practices embedding the fundamentals of al-Shariah and aligned with global sustainable and investment principles. Figure 2 draws the lines of how these principles can be streamlined with the objectives of Shariah to design products and services, including Sukuk.
- **Compliance and operational considerations:** Inconsistent legislation and reporting practices in different markets and jurisdictions pose challenges and operational risks to investors and issuers.

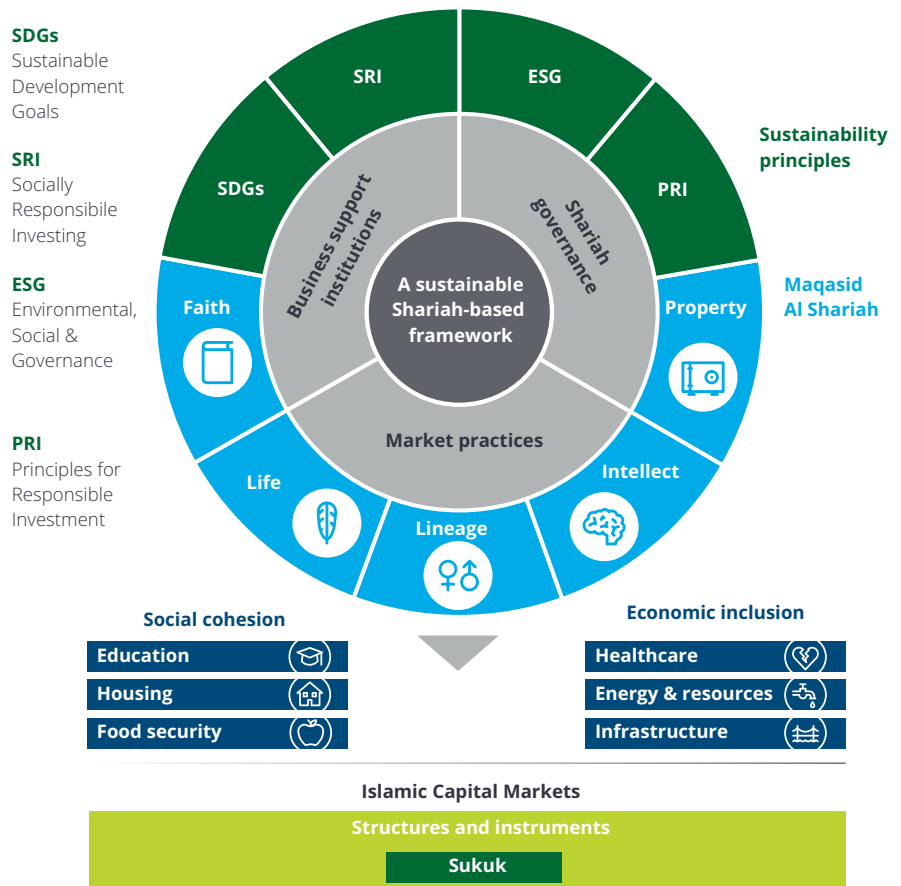
However, embracing a sustainable Shariah-based framework to fund projects in key priority sectors can enhance the Sukuk market and increase its convergence to global capital markets. In essence, this will help boost the drive to global common practice.

Table 2: Differences between responsible investment and Islamic finance

	Responsible investments	Islamic finance
General investment approach	Holistic approach that aims to include any Environmental, Social and Governance (ESG) information that could be material to investment performance.	Value-based approach that has mainly focused on exclusionary screens on specific social and economic grounds.
Active ownership	Strong emphasis on being active owners and to engage with companies on ESG issues (including proxy voting).	No widespread practice of engagement or active ownership.
Avoiding investments in highly leveraged companies	Not widely considered.	Sophisticated approach to analyzing financial structures of corporate entities to understand cash flows and avoid investments in companies with excessive leverage.
Impact	Not widely considered, but there is a growing focus on environmental and social impacts of investments (including contributions to the SDGs).	Shariah scholars have typically assessed the compliance of financial products from a structural and legal perspective – the focus is not on actual impact or real economy outcomes.

Source: Principles for Responsible Investments (PRI)

Figure 2: Embracing common practices through a sustainable Shariah-based framework



Source: Deloitte Research and Analysis

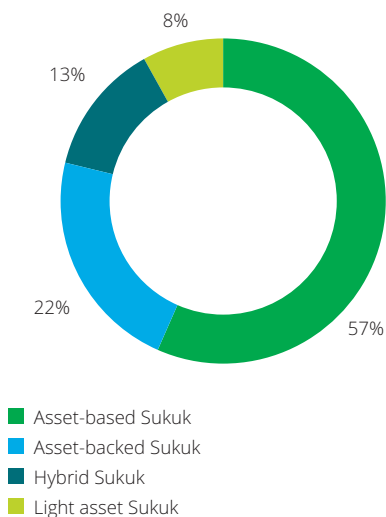
Practice and market institutions

In this section, we highlight some of the main views shared by participants from our online survey conducted in summer 2017. Whilst the focus was on Shariah-related functional and operational issues, we also offered participants an opportunity to express views through an open-ended question to address other practice and investment challenges relating to Sukuk structures, investment and regulatory development.

We follow this analysis with contributions from selected industry experts to share their respective views on the topical issues addressed in this report and how best we can align thinking around a global common practice for the Sukuk market.

Sukuk structures and investors' preference

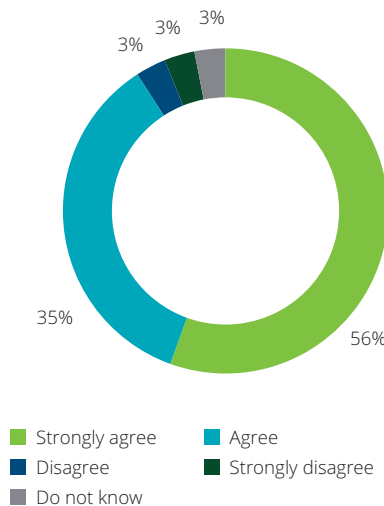
Figure 3: What is the most widely used Sukuk structure in your country/jurisdiction?



- 57% of respondents agree that the asset-based Sukuk structure is widely used in their countries while 22% of the respondents view the asset-backed Sukuk as the common structure.

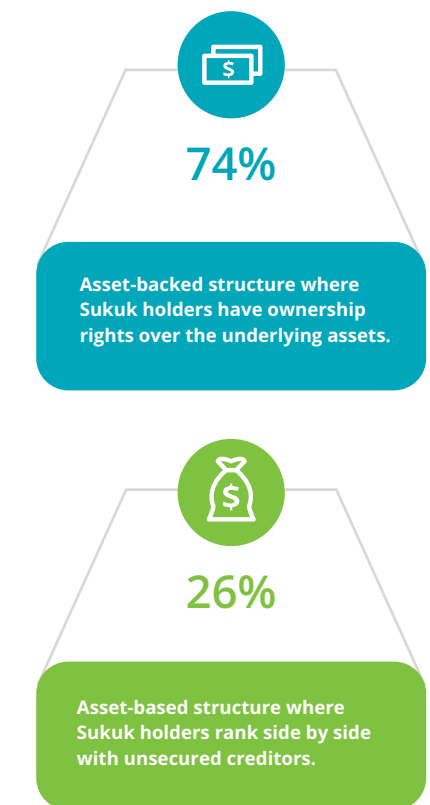
- 13% and 8% believe that Hybrid Sukuk and asset-light Sukuk are widely used as well.
- Recently, Saudi Aramco has used the Hybrid Sukuk structure for issuing a domestic offer of riyal-denominated Sukuk.

Figure 4: To what extent do you agree with the notion that the Sukuk market requires more innovative structures to cater for the capital needs of corporates and lack of assets ('Ayn)?



- Generally, the Sukuk market has developed numerous structures including perpetual Sukuk and convertible Sukuk.
- As markets grow, it appears there is demand for more innovation as seen by respondents.
- 56% of respondents strongly agree that the Sukuk market requires more innovation while 35% of respondents agree to the need for innovation.

Figure 5: In your opinion, which Sukuk structure is more likely to attract investors from the following two types?

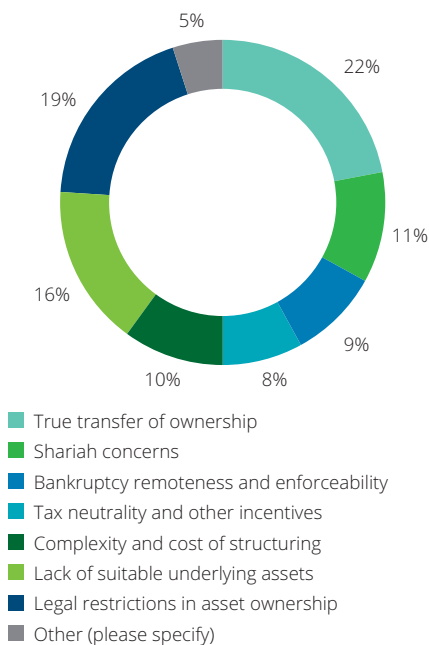


- A majority of 74% of participants believe that asset-backed structures are more attractive to investors than asset-based structures.
- This is attributed to that the fact that Sukuk holders have legal ownership with right to dispose the assets and they have recourse to the asset in case of defaults.
- Investors always seek more security and prefer to have some of form of assurance regarding ownership rights over the underlying assets.
- Nonetheless, asset-based Sukuk structures are widely used despite their disadvantages over asset-backed notes.

Practice and Shariah challenges

A better understanding of Shariah compliance concerns can help improve operational and functional processes and significantly reduce risks and costs associated with that. To assess these issues, we designed a set of questions to obtain more clarity from industry practitioners.

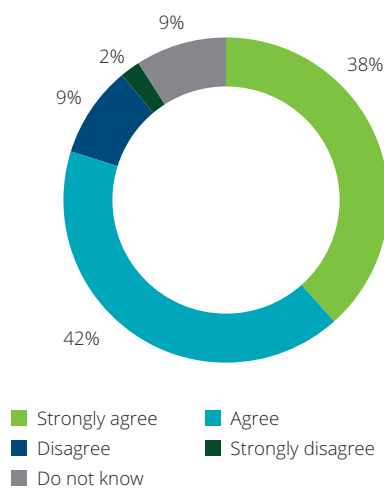
Figure 6: In your opinion, what are the key reasons that impede Sukuk issuers/investors from opting for an asset-backed Sukuk structure? Please select your top three answers.



- Our survey respondents indicate that there are various reasons that might impede Sukuk issuers and investors from opting for an asset-backed Sukuk structure and the most prominent reasons include a true transfer of ownership, legal restrictions, and the lack of suitable underlying assets.
- 22% believe the issue of true transfer of ownership is the main reason that hinders Sukuk issuers and investors

from opting for an asset-backed structure whereas 19% believe the problem stems from legal restrictions in asset ownership.

Figure 7: The use of asset-light Sukuk, in the absence of tangible assets ('Ayn), has given rise to a number of Shariah concerns such as tradability. To what extent do you agree with this statement?

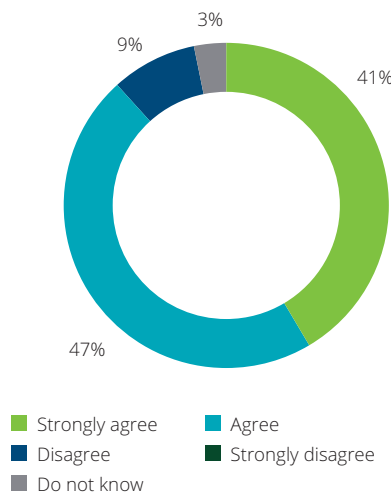


- Tradability of Sukuk remains an unresolved issue and different views have emerged, particularly to the fact that there is an absence of tangible assets in the case of the asset-light Sukuk.
- 42% of respondents agree that the use of asset-light Sukuk, in the absence of tangible assets, has given rise to a number of Shariah concerns such as tradability.
- 2% strongly disagree with this statement and 9% disagree to an extent.

Our survey respondents indicate that there are various reasons that might impede Sukuk issuers and investors from opting for an asset-backed Sukuk structure and the most prominent reasons include a true transfer of ownership, legal restrictions, and the lack of suitable underlying assets.

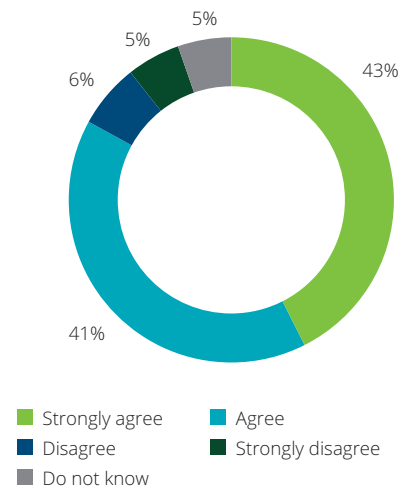
Central to the Sukuk investment structure is the element of repurchasing the asset at maturity and the majority of our respondents believe that more clarity and guidance is required.

Figure 8: In asset-based Sukuk, the right of disposal of the underlying asset continues to pose serious Shariah concerns. To what extent do you agree with this statement?



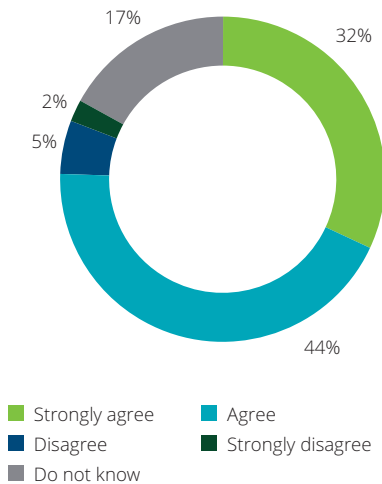
- The disposability of the underlying assets in asset-based Sukuk continues to cause challenges.
- 41% strongly agree that the right of disposal of the underlying asset continues to pose serious Shariah concerns.
- 9% disagree with the above statement and do not think of the disposal of underlying assets as an issue.

Figure 9: The AAOIFI is required to provide more clarity and guidance on the repurchase of assets at maturity whether at par value, original sale price, market value or fair value. To what extent do you agree with this statement?



- Central to the Sukuk investment structure is the element of repurchasing the asset at maturity and the majority of our respondents believe that more clarity and guidance is required.
- 43% strongly agree that the AAOIFI is required to provide more clarity and guidance on the repurchase of assets at maturity whether at par value, original sale price, market value or fair value. However, 5% of respondents strongly disagree with the statement.

Figure 10: The IIRA's Fiduciary ratings concept is 'welcome news' to the industry and should be widely accepted as good practice to strengthen Shariah governance and investor confidence. To what extent do you agree with this statement?



- Ratings of Sukuk remain at the forefront of investment in Sukuk and all credible rating agencies now have developed different analysis models for Sukuk.
- A unique fiduciary rating approach was developed by the IIRA and our survey respondents have strong supportive views on this concept.
- Three quarters of the survey's participants view the concept as a good practice to strengthen Shariah governance and investor confidence.

Table 3 illustrates some recent practice initiatives led by industry Standard-Setting Bodies (SSBs) to improve practices relating to Sukuk investment, issuance, standardization and compliance.

Table 3: Key recent development by Standard-Setting Bodies (SSBs)

IFSB	<p>The IFSB launched, for consultation an Exposure Draft (ED-21): Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)</p> <p>The main objective of ED-21 is to provide a set of core principles for the regulation and supervision of the Islamic capital market (ICM), taking into consideration the specificities of Islamic finance, while complementing the existing international standards, principally International Organization of Securities Commissions' (IOSCO) objectives.</p>	<p>IFSB-19, Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (Sukuk and Islamic Collective Investment Schemes)</p> <p>IFSB-19 outlines disclosure requirements for Sukuk and ICIS, covering the main stages of disclosure, i.e. initial, ongoing (periodic and immediate) and point-of-sale disclosure. In addition, the document provides guidance on the disclosure requirements for private offerings, government and multilateral issuances, and cross-border issuances with regard to Sukuk.</p>
AAOIFI	<p>AAOIFI's new and revised accounting standards on Sukuk</p> <ol style="list-style-type: none"> 1. Exposure draft: FAS 34 - Financial Reporting for Sukuk Holders 2. Exposure draft: FAS 29 - Sukuk Issuance 3. Exposure draft: FAS 25 - Investment in Sukuk, Shares and Similar Instruments 	<p>UAE Adoption of AAOIFI standards:</p> <p>According to the recent pronouncement, all full-fledged Islamic banks, Islamic windows of conventional banks, and finance companies offering Shariah compliant products and services in the UAE are required to comply with the AAOIFI standards with effect from 01 September 2018.</p>
IIRA	<p>IIRA to operate as a licensed credit rating agency in the Sultanate of Oman:</p> <p>The IIRA has been authorized as a credit rating agency in Oman according to the communication by the Capital Market Authority (CMA) of Sultanate of Oman with IIRA.</p>	
IIFM	<p>IIFM Standard No. 12: Sukuk standardization (to commence soon):</p> <p>As per IIFM, consultation process on the Sukuk standardization project will involve the development of specific guidelines and standard documentation on Ijarah Sukuk.</p>	

Source: Compiled by Deloitte Research and Analysis

These important practice considerations, in our view, strengthen the case for global common practices in Sukuk markets to enhance regulatory strategy capabilities for the larger debt and capital markets and streamline fragmented markets.

Moreover, the AAOIFI has been engaging industry stakeholders in a process of reviewing its standards, which includes revised accounting standards on Sukuk FAS 29: Sukuk Issuance and FAS 34: Financial reporting for Sukuk Holders (EDs issued, being finalized) along with revision of FAS 25: Investment in Sukuk, Shares and Similar Instruments. A summary of these developments is shown in Figure 11.

It is also worth noting that the Islamic International Rating Agency (IIRA) has developed a unique approach to rate and assess risk related to sovereign Sukuk, which needs to be widely communicated, improved if required, and used.



الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

Sovereign rating by IIRA

The six basic categories used by IIRA in analyzing sovereign Sukuk:

- Politics and policy continuity
- The Economy–Structure and Growth Prospects
- Budgetary and Fiscal Policy
- Monetary Policy and Flexibility
- The External Accounts
- Internal and External Debt

Figure 11: AAOIFI's new and revised accounting standards on Sukuk



Source: AAOIFI Standards

Regulatory capabilities and market development

Asia Sukuk markets – Malaysia: A trajectory growth of Sukuk markets

By Dr. Salma Sairally, Research Consultant, ISRA

Since Malaysia's first corporate Sukuk issue by Shell MDS Malaysia Sdn Bhd in 1990, the country has evolved into one of the world's most advanced and largest markets for Sukuk origination and investment. According to the MIFC, as at end-April 2018, Malaysia accounts for 51.7% of global Sukuk outstanding compared to other jurisdictions such as Saudi Arabia (19.1%), the UAE (8.1%), Indonesia (7.5%), Qatar (4.1%) and others (9.5%). The healthy and sustainable pipeline of Sukuk issuance that the country enjoys, from both the public and private sectors, is backed by a strong value proposition for Sukuk, placing it at a comparative advantage over conventional bonds.

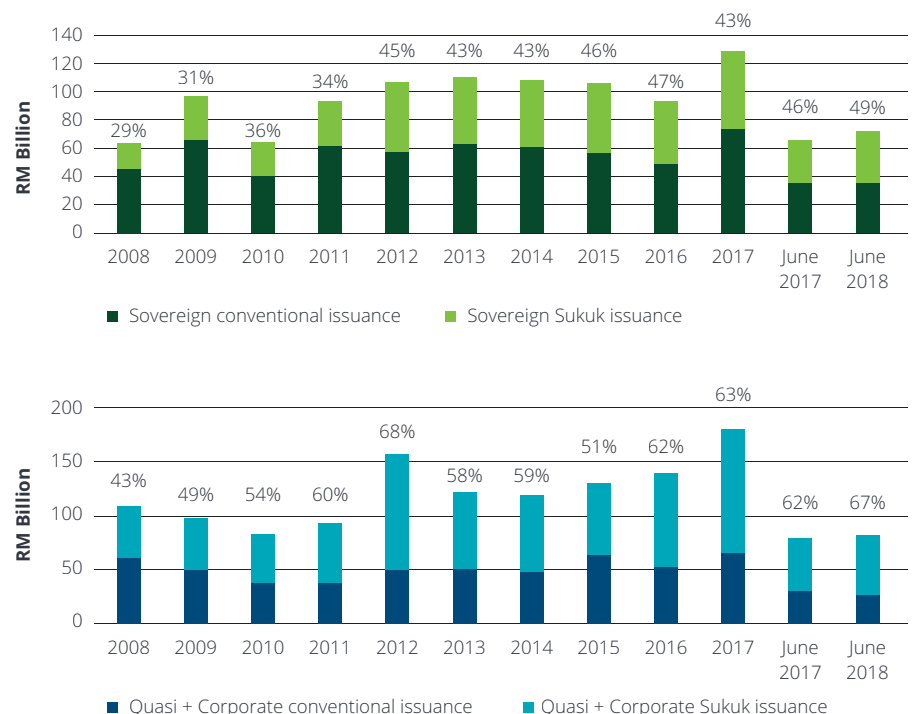
Malaysia's strategic vision

Malaysia's leadership position in the Sukuk market is not a haphazard occurrence. It is a result of the collective and coordinated efforts of the Government of Malaysia (GoM), the regulators as well as market players to spur national economic growth through the strategic development of the financial services industry, including Islamic finance. The financial services industry is one of the 12 national key economic areas (NKEAs) under the Economic Transformation Programme (ETP), which

seeks to elevate the country to developed-nation status by 2020. The decision to include Islamic finance as a policy tool in GoM's economic agenda has been the driving force behind the country's successful development of its overall Islamic capital market (ICM), including the Sukuk market.

Based on the Securities Commission Malaysia's Securities Commission (SC) data, the size of the ICM as a percentage of Malaysia's capital market has already surpassed 60% as at May 2018. Growth of the ICM has been supported by an active corporate Sukuk market as well as regular issuance of sovereign Sukuk to fund GoM expenditure.

Figure 12: Malaysia's conventional vs. Sukuk issuances (2008 to end- June 2018)



Source: BPAM, RAM

The facilitative infrastructure put in place has led to several financial engineering efforts to emanate in Sukuk structures. This has spearheaded Malaysia's strong reputation as a center for Sukuk innovation.

The progressive expansion of the ICM is also an outcome of the strategic vision embedded in the SC's Capital Market Master Plans (CMP), i.e. CMP (2001-2010) and CMP2 (2011-2020). These blueprints mapped out the long-term development of the Malaysian capital market into a well-regulated international ICM center which fosters 'growth with governance'.

Domestic Sukuk market evolution

Over the years, in support of its aspiration to promote Malaysia as an international ICM, the GoM has progressively increased its Sukuk vis-à-vis bond issuances. In total, Sukuk represent 52% of Malaysia's bond market as at June 2018 and sovereign Sukuk, as shown in Figure 12, represent 49% of total government securities, compared to only 29% as at end-2008. Meanwhile, the share of corporate Sukuk issuances, including quasi Sukuk, has increased from 43% to 67% over the same period. One of the advantages of the GoM's active participation in the Sukuk market is that it has helped to set the necessary benchmark yield curve for corporate issuances.

Malaysia features among the world's most active corporate Sukuk market with issuances across various sectors (e.g. financial services, infrastructure and utilities, transportation, property and real estate). Thanks to high demands from cornerstone institutional investors such as Employee Provident Funds (Kumpulan Wang Simpanan Pekerja), Hajj Funds (Tabung Haji), Retirement Fund (Kumpulan Wang Persaraan) and many others. Institutional investor base in Malaysia is considered the most well-developed in OIC countries.

The prominence of corporate Sukuk issuances is a result of GoM's efforts to promote the private sector as an engine of economic growth. To this end, a number of fiscal stimuli has been accorded in the form of income tax deduction, real property gains tax exemptions and stamp duty exemptions to set the level playing field between Sukuk and bonds.

In addition, tax incentives have been introduced such as tax deductions to the issuer on Sukuk issuance expenses for Ijarah Sukuk and Wakalah sukuk that comprise a mixed portfolio of assets. In general, this fiscal incentive adds to the attractiveness of Sukuk vis-à-vis bonds. It has further promoted the issuance of 'asset-light' Sukuk structures which have increased in popularity in light of the difficulty of finding suitable tangible unencumbered assets to serve as underlying assets for the Sukuk structure. The use of the Wakalah structure, for example, enables the issuer to utilize certain assets such as Shariah-compliant shares, vouchers representing entitlement to a specified number of travel units on public transportation services as well as Murabahah and Istisna' receivables to form part of the portfolio of assets (such as in the case of the GoM Wakalah Global Sukuk 2016).

The GoM has liberalized the mandatory credit rating for bonds and Sukuk issuance starting from 01 January 2017. Such removal is deemed as a positive response to the growing demand for higher-yielding securities in the global economy. It also aims to encourage domestic credit rating agencies to upgrade their services and take a more regional or global approach to their business.

Sukuk innovation

The facilitative infrastructure put in place has led to several financial engineering efforts to emanate in Sukuk structures. This has spearheaded Malaysia's strong reputation as a center for Sukuk innovation. Pioneering structural enhancements have, for instance, evolved for tax efficiency reasons, to improve Shariah compliance, to resolve issues about encumbered Shariah-compliant assets, or to support higher credit ratings. Figure 13 depicts Malaysia's trailblazing position with many 'firsts' in terms of Sukuk structures.

Latest market trends

One of the recent market developments pertains to the introduction of retail Sukuk which seeks to make Sukuk accessible to individual investors and increase retail participation in the market. In September 2012, the SC launched the Retail Bonds and Sukuk Framework to enable retail Sukuk to be issued and traded in Malaysia. The retail Sukuk market was introduced in phases to allow time to retail investors to gain understanding and familiarity with investing and trading in Sukuk. The first Malaysian retail Sukuk issued under the framework was in 2013 by DanaInfra Nasional Berhad to meet the capital expenditure and operation expense under one of the country's biggest infrastructure projects, notably the Klang Valley mass rapid transit (MRT) line. Subscriptions were in multiples of RM1,000 (about US\$232) making the investment affordable to Malaysian citizens.

Another latest trend in the market is the issuance of Sustainable and Responsible Investment (SRI) Sukuk the first SRI Sukuk issued for the purpose of financing education was by Khazanah Nasional Berhad in June 2015 under the SC's SRI Sukuk Framework (2014). SRI Sukuk align

Figure 13: Malaysia's strong reputation as a centre for Sukuk innovation

1990	First corporate sukuk - Shell Malaysia Shd Bhd
2001	First quasi-sovereign global Sukuk - Kumpulan Guthrie
2002	First rated global sovereign asset-based Ijarah Sukuk - Government of Malaysia
2006	First exchangeable Sukuk - Khazanah Nasional Berhad
2011	First Wakalah global Sukuk - Government of Malaysia
2015	First SRI Sukuk for education - Khazanah Nasional Berhad
2017	First corporate green Sukuk - Tadau Energy Shd Bhd

Source: ISRA

with the rising convergence of Islamic finance with various streams of ethical finance such as environmental, social and governance (ESG), sustainable/impact/green investments, the United Nations Principles for Responsible Investment (UN-PRI) and value-based intermediation (VBI, an ongoing initiative of the Malaysian Central Bank). Altogether, these initiatives aim to accomplish the UN Sustainable Development Goals (SDGs) which seek to transform the world by targeting several socio-economic development issues by 2030. The second tranche of the Khazanah Nasional Berhad SRI Sukuk in July 2017—which aligns with the UN SDG of improving accessibility to quality education—contained a retail component, allowing individual Malaysians to invest in a good cause.

Table 4: Tax incentives for retail and SRI Sukuk

Recipient	Incentive	Reference legislation
Issuer of retail Sukuk	<p>Tax deduction on additional expenses incurred on the issuance of:</p> <ul style="list-style-type: none"> • retail Sukuk structured pursuant to the principle of Murabahah or bay' bithaman ajil (based on the concept of Tawarruq), Mudharabah, Musharakah, Istisna' or any Shariah principle other than the principle mentioned below, • retail Sukuk structured pursuant to the principle of Ijarah, or Wakalah comprising a mixed component of asset and debt, approved or authorized by the SC from the year of assessment 2016 until the year of assessment 2018. 	Income Tax (Deduction for Expenditure on Issuance of Retail Debenture and Retail Sukuk) Rules 2016.
Issuer of Sustainable and Responsible Investment (SRI) Sukuk	<p>Tax deduction for the expenditure incurred on the issuance or offering of SRI Sukuk approved or authorized by, or lodged with, the SC for the year of assessment 2016 until the year of assessment 2020.</p> <p>The tax deduction is applicable to SRI Sukuk in which 90% of the proceeds raised from the issuance or offering of the SRI Sukuk are used solely for the purpose of funding SRI projects as specified in the guidelines by the SC.</p>	Income Tax (Deduction for Expenditure on Issuance or Offering of Sustainable and Responsible Investment Sukuk) Rules 2017

Source: Securities Commission Malaysia

To promote both retail and SRI Sukuk, the GoM has incentivized issuers with the following income tax deductions, as stipulated in Table 4.

With the growing concern for the environment and its preservation, Malaysia has also been leading the green SRI Shariah-compliant financing stream. It has launched several green SRI Sukuk, as described in Table 5. Again, issuers of green SRI Sukuk have benefitted from ample GoM support. In addition to tax incentives introduced to attract green issuers, the SC established a Green SRI Sukuk Grant Scheme for an amount of RM6 million. The scheme incentivizes issuers to seek green certification by offsetting external review costs of up to 90% subject to a maximum of RM300,000 (about US\$69,767) per issuance. The grant is open to both domestic and foreign companies for Sukuk issued in Malaysia in any currency up to December 2020. In addition, grant recipients enjoy income tax exemption.

The future of green Sukuk is certainly promising in Malaysia. As the President/CEO of Cagamas at the IFN Asia Forum 2018 said, this is in light of the GoM's aspiration to position the country as the home for SRI and to support Malaysia's Green Technology Master Plan which targets the country as a green technology hub by 2030.

Table 5: Malaysia's Green SRI Sukuk (as at June 2018)

Tadau Energy Sdn Bhd	Issued the first corporate green SRI Sukuk in Malaysia in July 2017 totalling RM250 million (about US\$58 million) for financing a 50-megawatt solar power plant.
Quantum Solar Park Malaysia Sdn Bhd	Issued the world's largest green SRI Sukuk in October 2017 worth RM1 billion (about US\$233 million) to finance the construction of three large-scale solar photovoltaic plants in the states of Kedah, Melaka and Terengganu, Malaysia.
PNB Merdeka Ventures Sdn Bhd	Issued a green SRI Sukuk in December 2017 totalling RM2 billion (about US\$466 million) to finance the construction of the Merdeka 118PNB Tower project which contains workplace safety, green and sustainability features.
Sinar Kamiri Sdn. Bhd	Issued a green SRI Sukuk in January 2018 totalling RM245 million (about US\$57 million) to undertake the development of a photovoltaic facility.
UiTM Solar Power Sdn Bhd	Issued a green SRI Sukuk in April 2018 totalling RM240 million (about US\$56 million) to fund a large scale renewable energy project.

Source: ISRA

Over the years, Malaysia has been successful in diversifying its investor- and issuer-base as well as increasing its cost competitiveness vis-à-vis other Sukuk markets. Malaysia has been a frontrunner in various arenas in the Sukuk market, including the development of an active Islamic money market.

Way forward

Over the years, Malaysia has been successful in diversifying its investor- and issuer-base as well as increasing its cost competitiveness vis-à-vis other Sukuk markets. Malaysia has been a frontrunner in various arenas in the Sukuk market, including the development of an active Islamic money market, the issuance of innovative Sukuk structures and the launch of green SRI Sukuk, among others. The latter has specifically strengthened Malaysia's position as a forerunner for Islamic sustainable finance. The current challenge is for the country to preserve its leadership position through greater penetration of retail investors and more awareness of green SRI Sukuk. The prospects of aligning Sukuk with sustainable initiatives, which are in line with upholding the objectives of the Shariah (Maqasid Al Shariah) and meeting the UN SDGs, may represent the key catalyst for Malaysia to further expand its Sukuk market. The launch of the Bond and Sukuk Information Exchange (BIX Malaysia) in 2017—a centralized and comprehensive information platform on issuers, credit risk and pricing—is envisaged to facilitate more retail participation in the Sukuk market and contribute towards transparency in both primary and secondary markets. Continuous support from both the government and the regulator is significant to increasing the value proposition of Sukuk as an undeniable competitive financing tool to issuers for sustainable development projects.

Asia Sukuk markets – Sukuk in Indonesia: Development, challenges and opportunities

By Dr. Hurriyah El Islamy, Executive Board Member, Badan Pengelola Keuangan Haji

Despite the slow growth of Islamic finance in Indonesia, Sukuk is gaining momentum. The government of Indonesia first issued sovereign Sukuk in 2008. The objectives were, among others, to provide an alternative source of funding for the Government, to offer Shariah compliant investment instruments and to promote Islamic finance. Sovereign Sukuk, known as SBSN being the short form for Surat Berharga Syariah Negara, also serves as the benchmark for corporate Sukuk issuance.

The development

Since 2008 up to 12 July 2018, the government has issued sovereign Sukuk totaling to Rp906.1 trillion of which Rp615.0 trillion is outstanding.

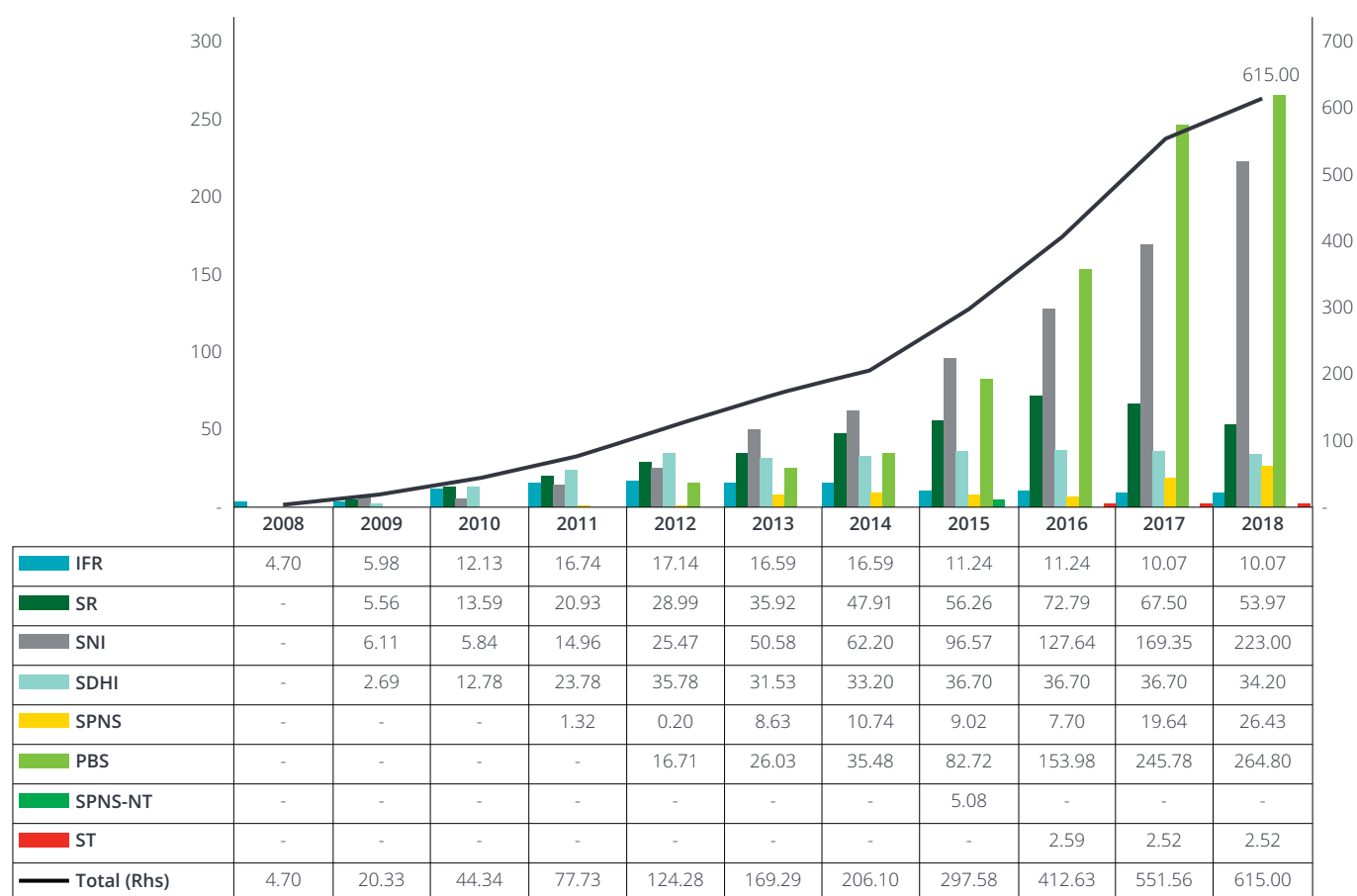
Outstanding Indonesian Sovereign Sukuk

Furthermore, since 2009 the government of Indonesia has issued sovereign Sukuk in foreign currency (namely US\$). As of today, the total sovereign Sukuk in foreign currency that has been issued by the government of Indonesia is US\$16.15

billion making Indonesia the largest sovereign Sukuk issuer ahead of Saudi Arabia, the UAE, Malaysia, Turkey, Qatar and Bahrain whose international sovereign Sukuk issuance stand at US\$9, US\$8.2, US\$7, US\$6.25, US\$6.23 and US\$5.2 billion respectively.

Indonesia is the first country in the world to have issued green global sovereign Sukuk. This year, as a manifestation of the government's commitment towards tackling environmental issues such as climate change, carbon emissions and

Figure 14: Outstanding Indonesian Sovereign Sukuk



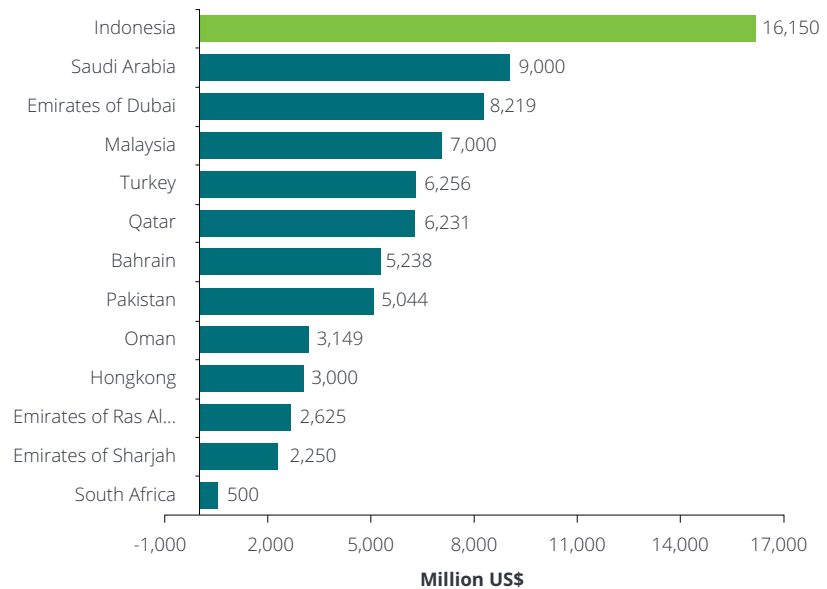
Source: Ministry of Finance, Indonesia.

other environmental problems, the government issued green global sovereign Sukuk totaling US\$1.25 billion. This has not only become the first green global sovereign Sukuk issuance, it was also the largest global Sukuk ever issued outside the GCC region. Indonesia has also become the largest international Sukuk issuer in the world for having issued the total of US\$16.15 billion Sukuk in less than a decade after its first Sukuk issuance. Figure 16 below shows the growth of Indonesian sovereign Sukuk issuance.

The challenges

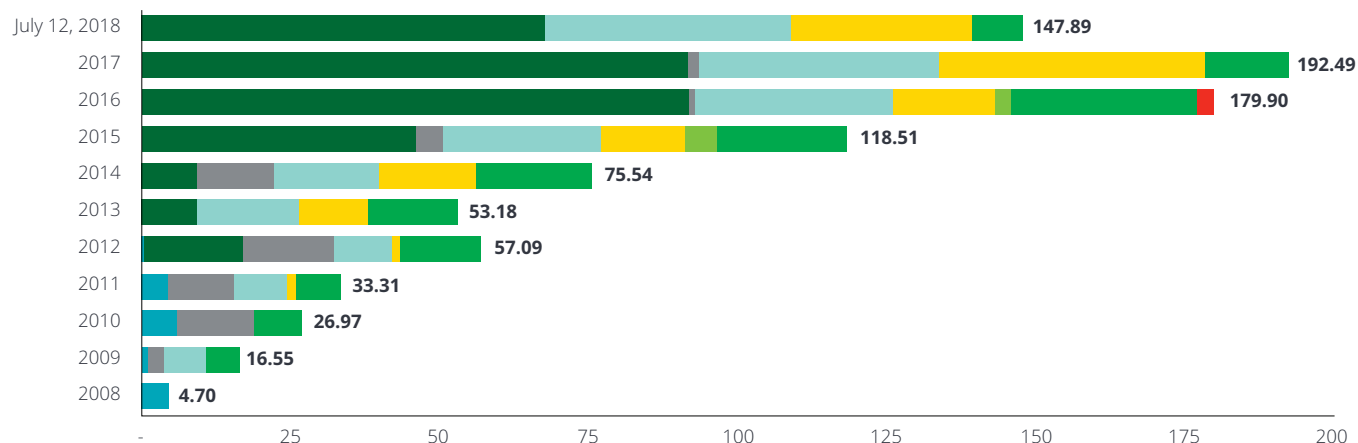
The absence of a supporting legal framework was a hurdle that discouraged the issuance of Sukuk. The ISRA-Deloitte survey which was conducted for the purpose of this study confirmed that 41.41% of respondents strongly agreed that lack of suitable underlying assets and legal restrictions in asset ownership have caused practical difficulties to issue Sukuk and the other 49.49% of respondents agreed to an extent. This is a common challenge that applies globally. In the case of Indonesia the matter has been rectified with respect to sovereign Sukuk issuances (Law Number 19 of 2008 on Sovereign Sukuk) but not for corporate Sukuk issuances. Secondly, despite the large number of sovereign Sukuk issuances, with the recent representing the largest one thus far, the Sukuk market in Indonesia is somewhat small in comparison to bonds as total Sukuk outstanding represents merely 18% of total bonds. Third, the secondary market

Figure 15: International (foreign currency) Sovereign Sukuk issuance



Source: Ministry of Finance, Indonesia.

for Sukuk has not been well established thus making even tradable Sukuk practically illiquid. Fourth, except for a small coupon margin offered by sovereign Sukuk, there has been no other financial incentive offered to make Sukuk more appealing to investors. Nonetheless, the coupon margin fails to attract investors as the offered margin does not warrant locking one's position for the entire term of the certificate, which is likely the case with the Sukuk market in Indonesia. Further, there has been no tax incentive for the issuer nor the investor for dealing with Sukuk which otherwise could motivate players to choose Sukuk over bonds.

Figure 16: The growth of Indonesian Sovereign Sukuk issuance

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	July 12, 2018
IFR	4.70	1.28	6.15	4.61	0.40	-	-	-	-	-	-
PBS	-	-	-	-	16.71	9.32	9.45	46.25	91.89	91.80	67.74
SDHI	-	2.69	12.78	11.00	15.34	-	12.86	4.50	1.00	2.00	-
SNI	-	7.03	-	9.04	9.64	17.24	17.75	26.42	33.41	39.97	41.38
SPNS	-	-	-	1.32	1.38	11.65	16.17	14.30	16.99	44.69	30.33
SPNSNT	-	-	-	-	-	-	-	5.08	2.54	-	-
SR	-	5.56	8.03	7.34	13.61	14.97	19.32	21.97	31.50	14.04	8.44
ST	-	-	-	-	-	-	-	-	2.59	-	-
Total	4.70	16.55	26.97	33.31	57.09	53.18	75.54	118.51	179.90	192.49	147.89

Source: Ministry of Finance, Indonesia.

The opportunities

The issuance of sovereign Sukuk, particularly the SDHI, has continued to increase to meet the demand for investment of a fund accumulated from pilgrimage fees. Similar trend applies to other types of sovereign Sukuk too. The growth was due to the increase of demand from both the institutional as well as individual investors.

The emergence of a new market player, Badan Pengelola Keuangan Haji (BPKH), the Indonesian pilgrims fund management agency has started to impact the Islamic finance industry. A market maker in the making, BPKH has cash (including Sukuk) under its management totaling to Rp113trillion (as at 30 June 2018). The size increases each

day as Muslims continue to pay the initial hajj fee contribution to reserve the entitlement to perform hajj (pilgrimage). The Government Regulations number five of 2018 dictates that during the first three years after the Agency establishment, not less than half of the fund is to be invested while the rest is placed with local Islamic banks (including Islamic windows). Motivated by such requirement, BPKH has been actively dealing with the Ministry of Finance and other market players to have Sukuk issued and within a few months, it has already placed Rp4 trillion in sovereign Sukuk and purchased further Rp1.7 trillion in addition to about Rp38 trillion sovereign Sukuk mostly in the form of SDHI it inherited from the Ministry of Religious Affairs.

Now that there are institutional players participating more actively in investment business transactions including Sukuk, it is expected that overall Sukuk growth in Indonesia will accelerate. As a sovereign agency BPKH is in the position to work together with ministries and other government agencies and to discuss and agree on transactions and/or approaches that will improve market practice. Initiatives are taken that in effect will remove some factors that remain as impediments in Shariah compliant investment transactions. While such action may be motivated by the objectives BPKH has to fulfill, it is expected that the Islamic finance industry as a whole will benefit from such change.

Asia Sukuk markets – Sukuk market development in Pakistan

By Mufti Hassaan Kaleem, Shariah Scholar

Sukuk has become an essential part of the Islamic financial system. In line with the global trend, the Sukuk Market has been consistently gaining ground in Pakistan's growing Islamic finance industry. There has been a concerted push by regulatory authorities in Pakistan to promote the Islamic finance industry on a sustainable basis. Regular Sukuk issuance has been a key element of this strategy as Sukuk make a number of options available to Islamic financial institutions for effective liquidity management.

Pakistan joined the global Sukuk market with issuance of its first international sovereign Sukuk of US\$600 million in 2005 and first domestic Sukuk a year later. Since then four international Sukuk amounting to US\$3.6 billion and 107 domestic Sukuk amounting to Rupees (Rs) 1,204.28 billion (US\$9.869 billion) have been issued.

Government sector issuances have dominated the Sukuk market, with approximately PKR 865 billion (US\$7.089 billion) being issued directly by the Government of Pakistan and around PKR 150 billion (US\$1.229 billion) by public sector entities. Over the same period, corporate Sukuk issuances are around PKR 170 billion (US\$1.393 billion). The Government of Pakistan tapped the international capital markets thrice during this time, initially in 2005 with a US\$600 million Sukuk, followed by two issuances of US\$1 billion each in 2014 and 2016.

In 2016, a total of 9 domestic Sukuk were also issued with a total value of approximately PKR 320 billion (US\$3 billion). Of these, around PKR 195 billion (US\$1.860 billion) were Government Ijarah Sukuk and PKR 100 billion were issued by public-sector entities (primarily the PKR 100 billion (US\$954 million) Neelum Jhelum Sukuk). New corporate Sukuk issuances stood at around PKR 26 billion (US\$248.115 million).

In the recent past, notable Sukuk within the corporate sector include the PKR 22 billion (US\$217 million) issue by K-Electric in 2014-15, the PKR 10.5 billion (US\$100 million) issue by Fatima Fertilizer in 2016, the PKR 7 billion (US\$66.800 million) issue by Meezan Bank in 2016 and the PKR 5 billion (US\$48 million) issue by Engro Fertilizer in 2016. Banks such as Al Baraka, Meezan and Dubai Islamic Bank have issued Sukuk to bolster their Tier 2 capital to comply with Basel III capital adequacy requirements.

In comparison with global issuances, the overall volume and size of the domestic Sukuk market in Pakistan is relatively small; the Pakistani Sukuk market was approximately 4% of global Sukuk issuances in 2016, which stood at US\$75 billion. Malaysia, the global Sukuk market leader, issued Sukuk worth approximately US\$35 billion in 2016, accounting for over 45% of the Sukuk issued globally that year. Indonesia and the UAE were the second highest issuers with issuances of approximately US\$7 billion each.

Government sector issuances have dominated the Sukuk market, with approximately PKR 865 billion (US\$7.089 billion) being issued directly by the Government of Pakistan and around PKR 150 billion (US\$1.229 billion) by public sector entities. Over the same period, corporate Sukuk issuances are around PKR 170 billion (US\$1.393 billion).

Regulatory development

The principal laws governing the issuance of Sukuk in Pakistan are:

1. Companies Act 2017 (the "Companies Act").
2. Trust Act 1882.
3. Companies (Asset Backed Securitization) Rules 1999 (the "Securitization Rules").
4. Debt Securities Trustee Regulations 2012.
5. Sukuk (Privately Placed) Regulations 2017 (the "Sukuk Regulations").

The Securities and Exchange Commission of Pakistan (SECP) had earlier issued the "Sukuk Regulations 2015" (the "2015 Sukuk Regulations"), which have now been replaced by the Sukuk Regulations. In July 2013, the State Bank of Pakistan (SBP) issued guidelines for the adoption of the AAOIFI Shariah Standard No. 17 on investment Sukuk (the "SBP Directive"). In addition, the Government amended the Income Tax Ordinance 2001, in 2016 to give Sukuk tax neutrality in comparison with other corporate debt instruments such as Term Finance Certificates (TFCs).

Growth trends

One of the major challenges that Pakistan's Islamic banking industry is facing is excess liquidity on the back of its growing deposit base, which constitutes around 14% of total banking deposits in the country. Whereas, if we look at Government borrowing/funding from conventional means and Islamic avenues, then the ratio is 95.5% and 4.5% respectively. If we further focus on Islamic banking deposits versus Government of Pakistan (GoP) Sukuk, then in 2011, the outstanding Sukuk were around 56% of Islamic banking deposits.

In 2017, this percentage has substantially dropped to around 22% of Islamic banking deposits, creating a widening gap which is alarming, as it may affect the overall growth trajectory of Islamic banking in the country. The GoP entered the domestic Sukuk market, with the issuance of PKR 6.5 billion (US\$108 million), in 2006, a year after it issued its first international sovereign Sukuk of US\$600 million. With three international and 19 local issues, the GoP has issued 22 Sovereign Sukuk in total till date. Out of 19 domestic issues, 16 issues carried a variable rental rate, whereas the last 3 domestic issues carried a fixed rental rate. The following Sukuk is the latest issue in the series of fixed rental rate Sukuk.

Sukuk structures

The Sukuk market in Pakistan is now maturing. Sukuk have confirmed their viability as an alternative means to mobilize medium to long-term savings and investments from a huge investor base. Different Sukuk structures have been emerging over the years but most of the Sukuk issuances to date have been Sukuk al-Ijarah. Other types of Sukuk like Salam, Musharaka and Wakalah are also playing a role for the government in major projects like motorways, bridges, railways, power plants, among others. As the universe of investors becomes more diverse, so too will their appetites, and with these there will be issuances beyond the currently prevalent structures like Wakalah bil Istithmaar based structure used in Dawood Hercules Sukuk and Power Holding Sukuk or Hybrid Sukuk based on Ijarah and Wakalah or Ijarah and Salam/Istisna' etc.

Pakistan's infrastructure needs for development projects covering China Pakistan Economic Corridor (CPEC) and other projects, can be achieved with the issuance of Sukuk. The Government of Pakistan has dominated the total volume of Sukuk issued in the country, in order to ensure the sustainable growth of Islamic banking and finance in the country, sovereign Sukuk need to be issued on a more frequent basis.

In this regard, regular structures for medium term Sukuk and other innovative structures may be explored. Additionally, the option of introducing Shariah compliant alternatives for T-Bills using Pakistan Mercantile Exchange Commodity Trading Platform, which would provide necessary depth and breadth to Pakistan's Islamic finance industry should be explored.

The Middle East: GCC Sukuk market

The GCC's debt capital market continued to be dominated by bond and Sukuk issuance, and Sukuk has become a key financing driver for infrastructure projects in the GCC and elsewhere in the wider MENA region. Both sovereign and corporate issues have surged in the first half of the year compared with the same period in 2017.

Conventional issuances represent US\$50.17 billion (80.19%) of the total GCC bond and Sukuk markets during H1 2018. Meanwhile, Sukuk issuances were US\$12.39 billion representing 19.81% of the total market in H1 2018. This is 30.84% lower compared to US\$17.93 billion raised in H1 2017, as reported by the Kuwait Financial Centre "Markaz", in its recent research report titled GCC Bonds & Sukuk Market Survey, July 2018.

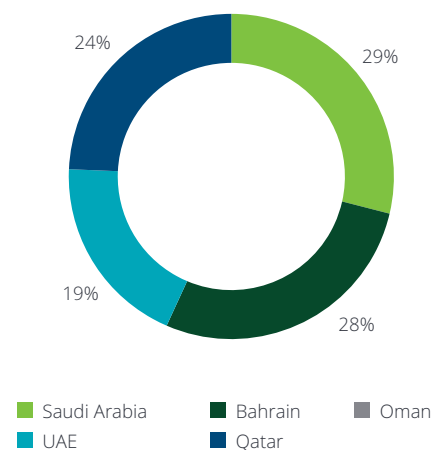
The report stated that the aggregate primary issuance of bonds and Sukuk by GCC entities, including Central Banks Local Issuances, GCC Sovereign and Corporate Issuances, totaled US\$95.25 billion in H1 2018, a 9.64% increase from the total amount raised in H1 2017. Qatar led the GCC issuances in terms of total value raised.

To reflect on this growth in the first half of the year, we have listed some of the key Sukuk issues, highlighting the sectors they served, yield, tenure and structures used in Tables 6 and 7. These issues were divided in parts in Q1 and Q2.

As can be seen in Figure 17, the Kingdom of Saudi Arabia (KSA) is the largest issuer accounting for 29% of issuances, followed by Bahrain which has continued to be a leading regional issuer of Sukuk. Sukuk Istithmar structure was the main type by the Saudi sovereign Sukuk issuance. In addition, Ijarah, Wakala and the Hybrid have been used for the corporate issuances. The US dollar is the main denomination currency for most issues. However, domestic currency issues in SAR, AED, BHD and OMR have been similarly used to support liquidity, market pricing and investors' requirements in the respective markets of the GCC. We have seen tenure varying from 7-10 years except for Al Rayan Bank's Sukuk issued for 34 years, marking a new horizon on Sukuk issues. The anchor issue is seen as a new development in corporate Sukuk, as it tapped into the real estate mortgage-backed assets space. Finally, almost all the Sukuk issues were rated and listed in local and international exchanges (dual listing in some issues), to meet investor's appetites and requirements.

Domestic currency issues in SAR, AED, BHD and OMR have been similarly used to support liquidity, market pricing and investors' requirements in the respective markets of the GCC.

Figure 17: Key leading GCC Sukuk issuance by country (Jan 2018 - July 2018)



Source: Deloitte Research and Analysis

Table 6: GCC Key Sukuk issuance Q2 (Apr 2018 – Jul 2018)

Date of issuance	Issuer name	Sukuk Name	Type of issuance	Structure	Sectors/ Use of Proceeds	Issuance currency	Issuance size	Profit rate (yield)	Tenor year	Sukuk rating	Exchanges
Jul-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	403,000,000	3.80%	10	NA	Tadawul Stock Exchange
Jul-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	962,000,000	3.62%	7	NA	Tadawul Stock Exchange
Jul-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	2,100,000,000	3.50%	5	NA	Tadawul Stock Exchange
May-18	Qatar Islamic Bank	QIB Sukuk Ltd	Corporate	Wakala/ Mudaraba	Banking/Financials	USD	120,000,000	1.900% + USD Libor 3 Months	5	Fitch: A-	Dublin Securities Market
May-18	Kuwait Finance House	KFH Sukuk Company SPC Limited	Corporate	Hybrid: Wakala/ Murabaha	Banking/Financials	USD	3,000,000,000	NA	NA	Moody's: (P)A1 senior unsecured long-term rating	NA
Apr-18	Bidaya Home Finance	Bidaya Home Finance Sukuk - Series 1	Corporate	NA	Real Estate/ Financials	SAR	250,000,000	3.75%	2	NA	NA
Apr-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	1,125,000,000	3.75%	10	NA	Tadawul Stock Exchange
Apr-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	1,500,000,000	3.50%	7	NA	Tadawul Stock Exchange
Apr-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	9,425,000,000	3.40%	5	NA	Tadawul Stock Exchange
Apr-18	Noor Sukuk Company Ltd	Noor Sukuk Company Ltd Trust Certificates 2023	Corporate	Wakala	Banking/Financials	USD	500,000,000	4.47%	5	A- (Fitch)	Nasdaq Dubai
Apr-18	Sharjah Islamic Bank	SIB Sukuk Company III Limited Trust Certificates 2023	Corporate	Ijarah	Banking/Financials	USD	500,000,000	4.23%	5	Moody's: A3	Irish Stock Exchange, Nasdaq Dubai
Apr-18	DAMAC Real estate Development	Alpha Star Holding V Limited (Damac)Sukuk	Corporate	Ijarah	Real Estate Management/ Financials	USD	4,000,000,000	6.63%	5	S&P BB	Nasdaq Dubai
Apr-18	CBB on behalf of the Government of the Kingdom of Bahrain	CBB International Sukuk Company 7 S.P.C.	Sovereign	Ijarah/ Murabaha	Government/ Budget Financing	USD	1,000,000,000	6.88%	7	B+ stable (S&P), B1 negative (Moody's), BB- stable (Fitch)	Irish Stock Exchange

Source: Compiled by Deloitte Research and Analysis

Table 7: GCC Key Sukuk issuance Q1 (Jan 2018 – Mar 2018)

Date of issuance	Issuer name	Sukuk Name	Type of issuance	Structure	Sectors/ Use of Proceeds	Issuance currency	Issuance size	Profit rate (yield)	Tenor year	Sukuk rating	Exchanges
Mar-18	Emirates Airlines	Zahidi Limited Trust Certificates due 2028	Corporate	NA	Transportation/ Financing of aircraft and working capital requirements	USD	600,000,000	4.50%	10	NA	Nasdaq Dubai
Mar-18	Dar Al Arkan Real Estate Development	Dar Al-Arkan Sukuk Company Ltd	Corporate	Ijarah	Real Estate Management/ Financials	USD	500,000,000	6.88%	5	Moody's: B1	Nasdaq Dubai, Irish Stock Exchange
Mar-18	IDB Group	IDB Trust Services Limited	Corporate	Wakala	Support the economic & social advancement goals in line with Shariah principles	USD	1,250,000,000	3.10%	5	S&P, Moody's and Fitch: AAA	Bursa Malaysia, London Stock Exchange, Nasdaq Dubai
Mar-18	Emirates of Sharjah	Sharjah Sukuk Program Limited Trust Certificates 2028	Sovereign	Hybrid	Banking/Financials	USD	1,000,000,000	4.23%	10	Moody's: A3	Irish Stock Exchange, Nasdaq Dubai/DFM
Mar-18	First Abu Dhabi Bank	First Abu Dhabi Bank Sukuk Company Limited	Corporate	Wakala	Banking/Financials	USD	650,000,000	3.63%	5	NA	London Stock Exchange
Feb-18	Qatar Islamic Bank	QIB Sukuk Ltd (Qatar Islamic Bank)	Corporate	Wakala	Banking/Financials	USD	49,500,000	NA	5	NA	Irish Stock Exchange
Feb-18	Al Rayan Bank	Tolkien Funding Sukuk NO.1 PLC	Corporate	Hybrid	Banking/Financials	GBP	250,000,000	LIBOR plus 80bps	34	Moody's /S&P: AAA	Irish Stock Exchange, London Stock Exchange
Feb-18	Albaraka Turk Participation Bank	Albaraka Turk Perpetual Sukuk	Corporate	Mudaraba	Banking/Financials	USD	205,000,000	10.00%	Perpetual	-	Irish Stock Exchange
Feb-18	Golden Group	Golden Sukuk Series 1	Corporate	Wakala	Create reputable branded hotels to enhance tourism sector & will create more employment opportunities for the Omani youths	OMR	50,000,000	6.50%	5	BBB+ by Capital Intelligence Rating Limited	Muscat Securities Market

Date of issuance	Issuer name	Sukuk Name	Type of issuance	Structure	Sectors/ Use of Proceeds	Issuance currency	Issuance size	Profit rate (yield)	Tenor year	Sukuk rating	Exchanges
Feb-18	Dubai Islamic Bank	DIB Sukuk Limited	Corporate	Ijarah	Banking/Financials	USD	1,000,000,000	3.63%	5	NA	Irish stock exchange ,Nasdaq Dubai /DFM
Jan-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	3,775,000,000	3.45%	7	NA	Tadawul Stock Exchange
Jan-18	Kingdom of Saudi Arabia	Saudi Government SAR Sukuk	Sovereign	Sukuk Istithmar	Government/ Budget Financing	SAR	2,050,000,000	3.85%	10	NA	Tadawul Stock Exchange
Jan-18	CBB on behalf of the Government of the Kingdom of Bahrain	Government Islamic Lease (Ijarah) Sukuk	Sovereign	Ijarah	Government/ Budget Financing	BHD	100,000,000	4.80%	3	NA	Bahrain Bourse
Jan-18	Sharjah Islamic Bank	Sharjah Islamic Bank Sukuk	Corporate	NA	Banking/Financials	AED	2,668,050,000	NA	10	NA	NA

Source: Compiled by Deloitte Research and Analysis

Recent regulatory development in the GCC appears to show efforts towards developing Islamic capital markets and lies on engagement with the private sector to fund capital investment projects.

Regulatory and policy responses

Recent regulatory development in the GCC appears to show efforts towards developing Islamic capital markets and lies on engagement with the private sector to fund capital investment projects. This can be seen by several initiatives and governmental support for building an effective debt capital market in many parts of the GCC. Essentially, the aim is to reduce reliance on governments to carry out infrastructure projects, given the recent budgetary constraints due to oil price falls among other reasons.

In the UAE, in the wake of practice development and challenges, the Securities and Commodities Authority (SCA), recently issued a resolution stipulating a set of rules and guidance to issuers of Islamic securities. Emphasis has been placed on practice enhancement and the need to disclose mechanisms of resolving disputes, such as reallocation of resources, and how to dispose of them or their revenues in the event the Sukuk or issuer no longer complied with the provisions of Islamic law; conflict of

interest that may arise from members of the Shariah Supervisory Committee; and the method of resolving disputes related to the Islamic financial paper. This applies to any issuer looking to offer Sukuk in the UAE – both local and foreign – as well as domestic issuers intending to tap the international market.

Other requirements included that “Fatwa issued for any Sukuk must detail the process of how the Shariah Scholars reached the Shariah opinion, and to support the pronouncement with legal evidence and disclosures.” This is particularly viewed as an improved Shariah governance practice to protect both Sukuk issuers and investors.

Another important aspect of adopting common practice is the resolution of the Higher Shariah Authority at Central Bank of UAE, to adopt AAOIFI Shariah Standards and making the AAOIFI Shariah standards mandatory for all institutions offering Islamic financial services (IIFSs).

Nasdaq Dubai: aiming at mature end of the Sukuk journey

- Sukuk issuers often see securities listing as key to liquidity, access to more investors and greater visibility to global institutional investors. However, improvements in listing requirements, trading, performance benchmarking and increased number of international centers of exchanges have helped growth of the Sukuk market globally. Nasdaq Dubai has developed into a leading regional and international exchange for global Sukuk listing and emerged as a catalyst platform for developing effective Islamic debt and capital market. Other international Sukuk listing centers include; London, Luxembourg, Dublin and Bursa Malaysia.
- While regional Sukuk listing is growing considerably, the Exchange has steadily improved listing rules, product offerings, technology and performance-related measures to keep pace with global market growth.
- One important feature developed by the Exchange is the development of a suite of Sukuk indices to provide Sukuk investors with timely performance benchmarks on price and liquidity aspects. These indices have a main index and sub indices designed for investment grade Sukuk, sovereign, corporate, financial and GCC-wide index.
- Another development was announced, as we write this report,

that the Nasdaq Dubai plans to allow individuals to invest in Sukuk market by 2019. This highlights a new phase of development in the Sukuk market leading to more mature end where small investors will have the opportunity to tap into the market and boost growth.

Can the Individual Investors help boost Sukuk Growth?

- Indeed, the proposed new rule changes will boost products innovation pace to design and articulate products with new risk and return profile. In turn, this will help broaden the investors base as it will attract a new set of investors from the region and international. The new products can also help to absorb much of the small idle savings, held by small investors. A new suite of investment solutions can be designed to fund priority social sectors.
- The new Sukuk designed for individuals investors will create a new category of investors which will require a whole set of ecosystem development and leveraging on emerged innovative technology investment platforms
- Likewise, the Exchange will strategically need to adopt new regulatory, operational and functional measures to accommodate for the new type of investors.

Indeed, the proposed new rule changes will boost products innovation pace to design and articulate products with new risk and return profile.

It is worth noting that the CMA and the Saudi Stock Exchange (Tadawul) have made a number of regulatory changes in recent months, ahead of the anchor Aramco's IPO. This includes a relaxation of regulatory qualification requirements for institutional foreign investors.

In the Kingdom of Saudi Arabia, similar new regulatory developments were introduced by the Kingdom's Capital Market Authority (CMA) to develop the Sukuk and debt capital market in the country. Key to this is the 'Rules of Offering Securities and Continuing Obligations', which aims to regulate the offering of securities in Saudi Arabia. It includes the conditions of the offer of securities, identifies the requirements of listing and offering, and the conditions and requirements of capital changes.

The CMA anticipates that the offer of securities and continuing obligations rules and the listing rules will contribute in many aspects, including greater flexibility of the public offering, development of new types of offerings, enhancement to the requirements of some types of offerings, and increased flexibility for the requirements of continuing obligations, noted Mohammed Elkuwaiz, Chairman, CMA.

It is worth noting that the CMA and the Saudi Stock Exchange (Tadawul) have made a number of regulatory changes in recent months, ahead of the anchor Aramco's IPO. This includes a relaxation of regulatory qualification requirements for institutional foreign investors.

In the Kingdom of Bahrain, early this summer, it successfully priced a Rule 144A/RegS international US\$1 billion 6.875% Oct-2025 Sukuk offering, reported the Central Bank of Bahrain. This issue comes at a time when growth rates show a surge and demand for capital to fund projects equally spurred.

This issue is significant for three reasons. First, it has strengthened confidence in Bahrain's debt management credibility and its prudential government policies to manage its funding needs. Second, it reinforces the role of sovereign Sukuk as a catalyst financing asset class for GCC states and other emerging markets. Third, global investors increasingly view Sukuk

as a good debt note to diversify their investment portfolio and Sukuk has become a key investment note amongst mainstream international investors.

In Kuwait, generally the Sukuk market is limited in scale and size and is constrained by limited policy support. However, the Capital Markets Authority (CMA) of Kuwait issued new regulations on Sukuk in November 2015 and a set of policy guidance to spur growth of the Sukuk market and investors' interest to tap the asset class as a catalyst for investment projects' financing in the country.

In a similar move, the Boursa Kuwait made several initiatives to improve reporting and transparency mechanisms for listed securities. The new online system is believed to help improve price discovery and contribute in providing liquidity, enabling special trades, and improving the settlement and clearing mechanism.

In the Sultanate of Oman, the Capital Market Authority, Sultanate of Oman (CMA) has since 2016, issued a set of rules and guidance to govern Sukuk issuance. The 'Sukuk Regulation' is developed to complement the existing bond regulatory framework, which is currently in place in the Commercial Companies Law and Executive Regulation of the Capital Market Law. This new Sukuk Regulation provided clarity and transparency to the market players, while providing protection to investors in a Sukuk transaction.

In Qatar, Sukuk issuance has become increasingly important as a corporate and government debt instrument. In a recent Bond and Sukuk survey, it was revealed that the GCC Sovereign and Corporate Issuances, totaled US\$95.25 billion in H1 2018, a 9.64% increase from the total amount raised in H1 2017. Qatar led the GCC issuances in terms of total value raised, reported Markaz.

Europe: UK and Luxembourg Sukuk markets

By Daud Vicary Abdullah, Managing Director, DVA Consulting Sdn. Bhd.*

As a non-Muslim country, the United Kingdom (UK) has long been at the forefront as a center for Islamic finance activity since the mid 1970's. More than 20 banks located in the UK offer Islamic financial services or products, 5 currently, are fully Shariah compliant. Many foreign banks access Islamic finance through the London markets or their London based teams for specific initiatives such as treasury funding, trade finance, property finance and agency desks for corporate financing. ICD Thomson Reuters Islamic Finance Development Report gives the UK an index of 16.2, which is the highest ranking of any non-majority Muslim country. London has the leading share of trading in many financial markets and has a proven platform for Islamic capital market development. International Sukuk issuances totaled nine in 2017, representing 20.5% of all Sukuk issuances in Europe for last year. The London Stock Exchange is a key global venue for the issuance of Sukuk. To date close to US\$50 billion has been raised through over 60 issues.

Similarly, the Luxembourg market has been an early adopter of Islamic finance. For example, Europe's first Islamic financial institution was licensed in Luxembourg and carried out operations from 1978 to the 1990's. In 1983, Luxembourg was the first European country to host a Takaful company. In 2002, Luxembourg's stock market was the first in Europe to list a Sukuk. In 2009, Luxembourg's central bank was the first European entity to become a member of the Islamic Financial Services Board (IFSB), the prudential/supervisory standard-

The Bank of England has been active in developing a Shariah compliant liquidity facility with availability beyond Islamic banks to possibly include Islamic mortgage firms, Takaful companies and Islamic leasing companies.

setting body for Islamic financial institutions. In October 2010, the Central Bank of Luxembourg was one of 14 founding members of the International Islamic Liquidity Management Company (IILM Co). The idea behind this institution is to create and issue short-term Shariah compliant financial instruments that will facilitate effective cross-border Islamic liquidity management.

As can be seen from the two paragraphs above, both the UK and Luxembourg have been proactive market leaders in the development of Islamic finance in Europe, and are rightly thought to be dynamic leaders in the global market. However, no market center can rest on its laurels and needs to be active in developing new strategies to sustain momentum in the future.

In the UK, the Bank of England has been active in developing a Shariah compliant liquidity facility with availability beyond Islamic banks to possibly include Islamic mortgage firms, Takaful companies and

Islamic leasing companies. In addition, a priority in the UK has always been to ensure the equivalence of Islamic finance with the conventional markets, particularly in the area of tax treatment. In terms of recent capital markets issuance by UK firms, perhaps the most outstanding example was the STG MBS Sukuk issued by Al Rayan Bank in February 2018 for GBP 250 million, which was oversubscribed by 155% and was designed to ensure that it was recognizable as High-Quality Liquid Assets (HQLA) and as a securitization under Central Registry Depository (CRD) definitions.

In terms of policy and actions as a result or related to Brexit there is nothing specific to report. Most UK practitioners see no diminishment in the UK's expertise in Islamic finance coming as a result of BREXIT. Indeed, some experts are saying that UK's experience may well be enhanced through greater engagement through FinTech and impact and green investment. What is also encouraging is

*With grateful thanks to Stella Cox CBE, MD of DDCAP, Shakeeb Saqlain, CEO of IslamicMarkets.com and Marco Lichtfous, Partner Deloitte Luxembourg for their valuable input.

Also encouraging in both UK and Luxembourg is the aspiration, among certain private sector firms, for the development of green Islamic Finance. These initiatives, like those related to Islamic Fintech, are being driven by private sector engagement through the likes of The City UK (TCUK) and Luxembourg for Finance. Government is participating informally, but organizations, such as TCUK, are invaluable in bridging private and public sector aspirations, drawing together the dialogue and lobbying. Both the UK and Luxembourg markets for Islamic Finance have developed and learned well over the last 30 years or so. The extent of development and depth of experience, particularly in the aspects of business, legal, tax and Shariah issues, should stand them in good stead as the world faces the challenges and opportunities presented as the result of developments in FinTech and the increasing realization that business has to be more and more focused on sustainability and recognize the benefits of responsible finance. The Sukuk industry is facing a number of global challenges. However, the contributions of both the UK and Luxembourg will go a long way to ensuring that Sukuk will be at the forefront of driving a sustainable industry transformation. The future can be bright, but there is much to do and not a moment to lose.

the development of a new generation of competent and business savvy young Shariah scholars in the UK market, who have a great awareness on the 17 UN SDG's and their alignment with the overall objectives on the Maqasid Al Shariah, this growing awareness and maturity will only serve the UK well on the global stage of the future. Harnessing, in a more holistic way, the expertise of responsible business and the Shariah, will provide the basis for a richer and more innovative Sukuk market.

In Turkey, since 2010, the Capital Markets Board (CMB) introduced regulation to support Sukuk issuance in the country. The Communique provided guidance regulating the principles and rules regarding board registration, issuance, and sale of Ijarah certificates, and the establishment and activities of asset lease companies. In 2012 and 2013, through a series of regulations issued by the Istanbul Stock Exchange (Borsa Istanbul), public and private lease certificates were accepted among eligible instruments that could be traded in the Debt Securities Market, and market conventions were regulated. In 2013, following the enactment of a new Capital Markets Law, the Capital Markets Authority widened the definition of lease certificates, allowing contracts to be based on ownership, management, trade, and partnership.

A key development to support Sukuk issuance was made by the amendments to several tax laws relating to stamp duty, corporate tax, and value-added tax related to Sukuk and the transfer of assets to asset leasing companies. Several other initiatives associate Islamic finance and Sukuk in particular with investment in real economy sectors such as renewable energy, and wider UN's SDGs. See case study on page 35.

Luxembourg's stock market was the first in Europe to list a Sukuk. In 2009, Luxembourg's central bank was the first European entity to become a member of the Islamic Financial Services Board (IFSB), the prudential/supervisory standard-setting body for Islamic financial institutions.

Case study: GIFIIIP's green Sukuk initiative

- In its efforts to align investment strategies with the UN's SDGs, the Istanbul International Center for Private Sector in Development (IICPSD), under the Global Islamic Finance and Impact Investing Platform (GIFIIIP) hosted stakeholders from public and private sector to build greater understanding of the role of Islamic finance in clean energy projects in Turkey.
- The meeting was organized as the first stakeholder consultation meeting for green Sukuk initiative launched under GIFIIIP. The initiative aims at three main goals: (i) facilitating access to finance for renewable energy projects in developing countries, particularly in the MENA region and OIC countries, (ii) providing financial solutions to environmental issues and (iii) expanding the role of Islamic finance in achieving the SDGs.
- Green Sukuk initiative will be piloted in Turkey and then replicated in OIC countries starting with the countries in the MENA region. The initiative has registered keen interest from investors. In Turkey, two domestic and one international green Sukuk issuances are currently under discussion, as an outcome of GIFIIIP'S green Sukuk initiative.
- Representatives from Republic of Turkey Ministry of Energy and Natural Resources, Capital Markets Board of Turkey and Republic of Turkey Prime Ministry under secretariat of Treasury participated in the meeting besides private sector representatives. The meeting focused on discussions on both the current landscape of Turkey's green Sukuk market and future opportunities. The meeting offered a unique opportunity to discuss challenges and opportunities regarding the green Sukuk market in Turkey and to identify potential solutions.

Green Sukuk initiative will be piloted in Turkey and then replicated in OIC countries starting with the countries in the MENA region. The initiative has registered keen interest from investors.

Regulatory support needed to drive Sukuk standards to boost growth and liquidity

By Khalid Howladar, Managing Director and Founder, Acreditus

The topic of Sukuk standards is an important but sometimes divisive one in Islamic capital markets and is a constant source of debate between many key industry stakeholders.

While many esteemed industry bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM) have worked or are working on standards, widespread market adoption remains limited given they are still in development and sometimes do not fit the objectives of the market's key stakeholders – the investors and issuers.

The Sukuk market still remains fragmented and Shariah-compliance driven structural complexity can expose investors to unnecessary legal risks and investment frictions that simply do not apply to conventional instruments, hence subduing global growth prospects and liquidity. Unfortunately, despite these problems being highlighted by recent industry challenges - little of substance has changed. Even though the English (governing law) courts ruled in favor of the investors, they have ultimately suffered a material loss due to these risks – not a good outcome for the industry.

The underlying issues stem from the inherent tension between the underlying equity, risk/profit sharing and asset financing principles of Islam and the current investor and issuer demand for a debt-like instrument. The varying Sukuk structures observed (Wakalah, Ijarah, Mudarabah, Murabahah, Musharakah and hybrids of the above) do not intrinsically have the same risk, return profile as the

desired 'bond' hence complex and sometimes-expensive legal engineering is applied to replicate the bond. This compromise is to reflect the perceived needs of a market that is still very immature and developing. Importantly, it should be noted that some Sukuk issues have the 'symptom' of the underlying structural/complexity issues.

The varying Sukuk structures observed (Wakalah, Ijarah, Mudarabah, Murabahah, Musharakah and hybrids of the above) do not intrinsically have the same risk, return profile as the desired 'bond' hence complex and sometimes-expensive legal engineering is applied.

Regulatory promotion of standards can have multiple beneficial effects for an industry that struggles to harmonize given the varying incentives and agendas of the stakeholders involved. Private sector issuers in the dominant 'unsecured' Sukuk market could benefit from reduced complexity and standards with lower costs, thus leading to higher issuance volumes, transparency and liquidity.

Ultimately, of all the parties, it is those with the 'money', who decide the success or failure of any market - including Sukuk. Aside from the above benefits, active regulatory endorsement of 'pragmatic'

versus 'idealistic' standards would boost confidence for international investors and help the sector mature. Standards would reduce the time and resources needed for newcomers and smaller investors to assess the risk of such investments and hence increase the number of participants – boosting trading and investment.

Standards across the different jurisdictions (a desirable but still unrealistic ideal) would allow greater and more resilient capital flows and investment opportunities between the active countries, creating a much larger market and attracting more investors and issuers to the Sukuk market – kick-starting a virtuous circle.

For some market parties (such as lawyers, fatwa providers, and bankers) standardization is a mixed blessing. On the one hand - such parties can benefit economically from the complexity of such transactions with the prospect of esoteric and individual (potentially higher) fees per transaction. On the other hand - such complexity consumes precious resources and human capital. Such parties could also benefit from the higher volumes (and more frequent fees) that a more standardized market could create.

Development of the sector is a key goal of most governments of Muslim majority countries and thus far, they have proven much more effective in driving growth than the private sector can achieve alone. Public agencies are responsible for exercising authority over the Sukuk capital markets in a regulatory or supervisory capacity. They provide administrative laws, regulations, transparency, supervision, disclosures and oversight for the benefit of all parties but typically focus on protecting investors.

Regulators also need to ensure a holistic view and have clear goals before setting policy – sometimes these goals can even conflict and these too must be managed carefully. National Shariah Boards are key for market confidence, improving market liquidity and reducing costs for issuers and investors. Their endorsement of market standards would support transparent and healthy growth.

The most quoted negative of standardization for the market is reduced variety and innovation. However, the chosen standards should address the needs of the nearly US\$450 billion mostly unsecured public market. This will not meet the needs of all issuers and it may not be the most orthodox or conservative structure. The author proposes that having market standards for these common 'unsecured' instruments would not constrain 'innovation'.

Indeed, all those who are not happy with the standards can still transact with each other. Nothing stops transactions outside the standard, but one can be assured the regulator-endorsed structures with their lower costs and better legal certainty will find favor with investors who will decide the shape of the market with their money. In all market related activities, the best way to move forward is to empower investors through transparency, governance and education – having standards supports all three of these objectives that are important to build a growing Sukuk market that all issuers and investors can have confidence in.

Development of the sector is a key goal of most governments of Muslim majority countries and thus far, they have proven much more effective in driving growth than the private sector can achieve alone.

Sukuk: A sustainable industry transformation, development of the alternative Sukuk market place

By Stuart Hutton, CIO, Simply Ethical

Over the past couple of decades, we have seen the Sukuk market slowly develop as a secure alternative to the conventional unsecured bond. By secure, it is the backing of an asset or its reflection of the real economy that has created an understanding that Sukuk and similar investment vehicles have an important role to play in the future of borrowing money.

In fact, in the recent survey by Deloitte and ISRA, it was evident that the asset-backed/based version of this instrument is the dominant player in the market (78.8%). We are seeing heightened interest in a more hybrid solution, offering easier access, but the fact that more than 95% of interest in Sukuk comes from the Asian, MENA, Africa regions, explains also why this broader perspective is still lacking depth.

What is frustrating for many is that despite the crippling effect of the credit crisis ten years ago, the Sukuk has not taken the opportunity to compete with the far larger and well-developed conventional global debt market. With default rates during this last decade lower than was expected to be, partly due to governments intervention in the money markets, there has not been the shift towards these alternatives.

However, is this all about to change?

With the fast development of solutions to achieve the United Nations 17 Sustainable Development Goals, a shift in both personal investment objectives and

With the fast development of solutions to achieve the United Nations 17 Sustainable Development Goals, a shift in both personal investment objectives and that of where best to invest institutional funds, is influencing a focus on a more green and social impact agenda.

that of where best to invest institutional funds, is influencing a focus on a more green and social impact agenda. Combine this with the notion that the Sukuk market requires more innovative structures, we are seeing potentially what a culture shift towards an exciting new area of how maybe everyone will lend their money in the future.

The green agenda has been strongly highlighted as a fast-growing area, with the need to shift from a carbon-based energy system to that of a clean renewable source. Like any shift of this nature, it is the infrastructure backing and delivering on this that requires financial support. The natural opportunity for investors has been to see this as a diversification away from potentially failing industries or at least shifting the funds to where they see it will be needed in the future.

One step even further into the unknown is lending to achieve positive social impact where this is needed. The significant difference here being that the performance of the investment is not financially gauged, but one of pre-agreed impact on an issue, for example related to health, education, or environment. The Social Impact Bond is truly in its infancy, with very limited scope and commitment. As a part of the global debt market, it does not even measure. However, when you look at recent innovative ideas on how this works and delivers, it is easy to understand why the financial markets are finally seeing how both “doing good & receiving good” do exist at the same time. No longer do you necessarily need to forgo some financial return in an almost philanthropic way to achieve both.

In May of this year, the Holy See Press Office of the Vatican released thoughts on this, expressing that economic and financial issues draw our attention to the growing influence of the markets on the material well-being of most of humankind. This has been mirrored by many other articles and speakers focusing on how for example the role of Waqf and Zakat in Islamic finance used for the alleviation of poverty and promoting social welfare is not being sufficiently effective.

If we start to link how the high-level focus on how we achieve the outcomes of more sustainable goals, and the impact individual investments have, as an industry, the financial markets have probably the most significant role in achieving this. This means that the instruments it uses now and develops for the future should include Sukuk like structures, focusing on delivery of transparent flow of funds for positive green and social return.

Of course, we do not live in an ideal world, and given the financial impacts of the last 100 years, it is easy to talk down the potential rewards. However, if innovation and collaboration, for example in use of technology like Blockchain, can combine with the traditional roots of responsible investing, as offered by Islamic Finance, there is no excuse.

So, what may be the answer? Well, it is about the education amongst professional investors and institutions. It is about harmonization of the approach to the use of Sukuk to offer a simpler route to market. It is about understanding the new type of investor that the ‘millennials’ will offer, as we see the transfer of wealth to the next generation. It is this, aligning with the desire and demand for alternative investments that will offer greater flows into the green and social impact marketplace, and if allowed, into Sukuk.

It is about the education amongst professional investors and institutions. It is about harmonization of the approach to the use of Sukuk to offer a simpler route to market.

Sustainability in focus

Development of green and sustainable Sukuk investment principles and the need for multi-stakeholder collaboration

A series of multi-stakeholder industry dialogues, led by Deloitte and supported by key leading industry institutions and seasoned industry practitioners, have been exploring the potential for developing globally recognised, common principles for the further development of the Sukuk market into green and sustainable practices. This could become a catalyst for accelerating the building of the long-sought full eco-system of the Islamic capital markets.

Deloitte's Sukuk market dialogue has historically had a broad agenda. Its focus currently includes the promotion and streamlining of practices within the global Sukuk market by embracing input and thought leadership from internationally

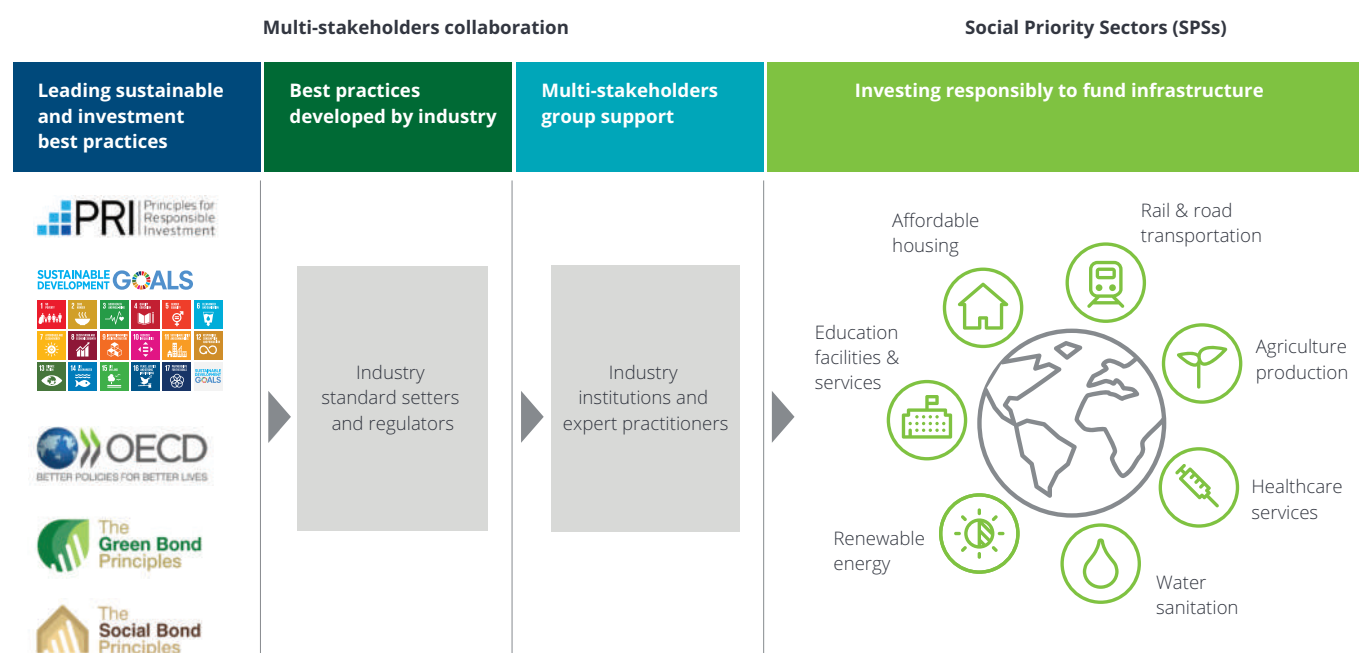
recognised organisations and initiatives. Amongst current workstreams and topics, Islamic investment and finance that is both sustainable and has positive social impact is high on the agenda.

To drive the themes, thoughts and insights discussed in this Report, and following the related thought leadership Roundtable that took place in London in 2017, a multi-stakeholder group of industry experts joined to collaborate on the development of green and sustainable Islamic capital market principles. The main objective of the Sustainable and Islamic Finance Initiative (SAIFI) is to bring together Sukuk practices with global green investment principles and promote international best practices in Islamic capital markets globally.

To this end, SAIFI is seeking support from key industry institutions and also policy support in key markets including the UK, Europe, the Middle East and Asia. SAIFI's initial focus is on environmental sustainability and, if sufficient progress can be made in this area, further work on social impact investing may follow.

Figure 18 below shows some of the organizations and initiatives relevant to the global development of responsible and sustainable financing practices and reflects how their output might link directly, or through collaboration, to Islamic financial sector development, including the Sukuk market, and sustainable and responsible investments that are green and / or have positive social impact.

Figure 18: Transforming the ecosystem of Sukuk investment market



Thinking further ahead: Practice and policy considerations

The strategic considerations prompted by the necessity of global common practices for Sukuk markets and the analysis provided, should be followed and revisited by industry stakeholders to take into the implementation phase. We believe that industry executives, policy makers and practitioners should consider bringing this debate internally in their respective organizations, focusing on the strategic Shariah governance, operational and technological implications towards building globally accepted practices for Sukuk.

Nevertheless, we have identified three main challenge areas related to the growth in Sukuk market that will require multi-stakeholder collaboration to be addressed effectively:

- New Sukuk structures are creating significant regulatory and Shariah challenges and acceptance by market leaders.
- FinTech products and services may give rise to competition and cost of raising capital in mid and long-term notes.

- Lagging behind in adopting global investment practices and principles discussed in this report such as the GBPs, PRI's, SDGs, ESG and green finance.

Policy support will drive greater harmonization on leading investment practices and will strengthen Sukuk acceptability as a leading investment asset class with its unique risk and return profile.

Other policy considerations were also identified across market practices considered in this study:

Streamlined regulatory support

Emerging global investment initiatives and technologies provide new ways to improve regulatory consistencies between key Islamic financial markets (Asia, Middle East and Europe). Signing to these investment initiatives will help boost regulatory convergence in a way or another.

Aligning investment structure innovations with Maqasid Al Shariah to finance priority sectors – identified in this report – will help achieve the values of Islamic finance of social inclusion.

Niche, specialized Sukuk

New innovative investment structures such as the one highlighted by the case study relating to renewable energy in Turkey, will create targeted products and services and attract new investors.

Serving priority sectors

Aligning investment structure innovations with Maqasid Al Shariah to finance priority sectors – identified in this report – will help achieve the values of Islamic finance of social inclusion.

Thinking further ahead, the drive for global common practices in Sukuk markets will become the base for building effective and efficient Islamic capital markets which can in turn integrate more effectively to global capital markets.

A global common practice in Sukuk markets can be viewed as a nexus for building an effective Islamic Capital Market which will serve priority sectors identified in this report.



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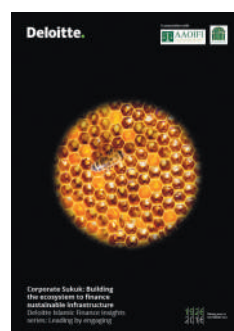
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