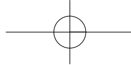

Tapping surplus liquidity

Islamic financial institutions are flush with cash, and banks are increasingly looking at sharia-compliant investments to park their money. It's sparked a flood of Islamic asset-backed securities issuance this year, with both Muslim and so-called conventional issuers keen to tap the market. By Alice Hales

Strange as it may sound, high oil prices could turn out to be the biggest stimulant the Islamic securitisation market has ever had. With oil hovering around $60 a barrel, there is a huge amount of liquidity in the Middle East, North Africa and parts of Asia. According to the General Council for Islamic Banks and Financial Institutions, pure Islamic-owned financial institutions have around $260 billion of assets under management. That doesn't include the estimated $200 billion–300 billion handled by the Islamic departments of global financial companies.

The good news for securitisation issuers is that this money needs to be put to work. "Middle Eastern liquidity needs to be invested and will continue to be a main engine of growth," says Tim Lupprian, head of primary markets for the central and eastern Europe and Middle East group at Standard Bank in London. "The power of precedent is important: as issuers are brought to market successfully, they create further demand. And there is no shortage of issuers keen to get access to these liquid and loyal investors."

Islamic securitisation issuers are beginning to exploit this liquidity, with new issuance increasing from $1.9 billion in 2003 to $6.7 billion in

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2004. Volumes are expected to top $10 billion in 2005, but many observers believe the market is capable of sustaining far greater levels than is currently the case.

Before examining the scope for growth, however, it is necessary to clarify how Islamic securitisation differs from conventional asset-backed securities (ABSs). Essentially, a conventional transaction involves the securitisation of cashflows linked to an underlying asset with investors paid an agreed rate of interest. However, under Islamic law – or sharia – interest payments are prohibited, so securitisation deals, known as 'sukuks', are structured in such a way that investors are exposed to business risk and rewarded according to the amount of risk they take on. In other words, they get paid a share of profits rather than receiving interest. Furthermore, a sukuk limits the amount of debt issued to the value of the assets held in the special-purpose vehicle (SPV).

The Accounting and Auditing Organisation of Islamic Finance Institutions recognises 14 types of sukuk. The most commonly issued are al-ijarah (leasing notes), where assets are sold by the issuer into an SPV then leased back for the deal's duration. When the notes mature, the originator is likely to buy back the assets.

To date, much of the issuance – at least offshore – has been done by sovereign or quasi-sovereign names. The Malaysian government kick-started the market in June 2002 with a $600 million deal arranged by HSBC and backed by lease payments. This was followed by offerings from Qatar, with its $700 million issue led jointly by Citigroup and HSBC in September 2003; Bahrain, with a $250 million deal arranged by the Liquidity Management Centre in February 2004; and Pakistan's $600 million issue via HSBC and Citigroup in February 2005.

Although each of the transactions was linked to underlying assets, most observers believe investors were mainly enticed by buying sovereign credit. The deals were structured with government guarantees, ensuring that if the underlying asset did not perform to expectations, investors would still get their money.

Incidental

"Islamic securitisation has largely been the domain of government issuers, and because of this, the assets have been incidental to the credit risk taken by investors," concedes a banker with experience advising on Islamic securitisation. "If you look at the Pakistan transaction, the underlying asset was a toll road, but there was no question of toll revenues being used to pay investors. They made a credit judgement primarily on the strength of the borrower."

Standard Bank's Lupprian says it was understandable for investors to act in such a way, but believes the market is already evolving from this mindset. "I think it was natural for the market to start with sovereign names, but as investors become more familiar with the product, it will be natural for them to move down the credit curve and take on corporate names," he states. "In fact, I expect corporate issuance could even exceed pure sovereign issuance in 2006. The residential property market, for example, has real potential."

There are good grounds for optimism. Along with more government-linked transactions by the likes of Dubai Metals and Commodities Centre (DMCC), which was arranged by Standard Bank (see pages 8–9), several non-sovereign deals have also been completed in the last year. Positively, activity has been spread across the Middle East and north Africa, with issues from Bahrain, Kuwait, the United Arab Emirates, Saudi Arabia, Lebanon and Egypt.

Some of the noteworthy recent deals include, Beirut-based Banque Europeenne pour le Moyen's $27 million transaction backed by a pool of vehicles and vehicle lease agreements in April 2004; while Arab Banking Corporation (ABC) and Abu Dhabi Commercial Bank put together a $26 million issue to finance the purchase of a large ship on charter to a Saudi Arabian shipping company in April 2005.

The market is not perfect by any means. For example, sukuks are not considered tradable in Saudi Arabia. In addition, distribution for the smaller corporate deals has often been restricted to one buyer, who then holds onto the paper for the term of the deal.

"A lot of deals end up being bought by the sponsors and when paper is distributed, it is frequently held on to by its first investor," says Duncan Smith, head of Islamic financial services, at ABC. "In a way, this speaks of what a new market this is, with more buyers of sukuks than sellers. Banks are happy to sit on securitised auto receivables in Saudi Arabia, for example, because they represent good risk, even though the pricing on these is pretty tight."

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>
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Advantages

Nonetheless, there are some clear advantages for issuers choosing the Islamic route over normal ABSs, says Smith, particularly as there are no limitations on who can issue or invest in sukuk bonds. "You have to remember that there are no conventional ABSs in the Gulf either, and in lots of ways, Islamic finance really leads the way in developing this market," he says. "When a bank like ABC pitches for business, it can always give the client the option of doing conventional or Islamic offerings. This broadens their options and opens up better pricing potential. Conventional banks already invest in Islamic finance deals. They do not look at sharia compliance; they look at the underlying asset and credit risk and at the underlying returns. In addition, a conventional security excludes the 30–40% of the market that is Islamic, while an Islamic issue can be – and frequently is – bought by Islamic and conventional investors."

Standard Bank's Lupprian agrees, adding that there is no rea-

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son why overseas borrowers should not look at issuing Islamic ABS deals themselves. "We should not ignore the scope for corporate issuance from the non-Islamic world. There is no impediment, other than haram (sinful activity), to issuing Islamic deals, and it represents a chance to access a different investor constituency," he asserts. "This has good implications for pricing, as long as they are familiar names to Islamic investors. We are not talking CCC-rated names here, but those with a strong credit history and good ratings."

The Government of Saxony has already tested the waters, becoming the first state entity from Europe to issue a sukuk offering in April 2004. The 100 million offering was led by Citigroup and Kuwait Finance House with 60% of the deal placed in the Middle East and 40% in Europe.

With so many positives surrounding Islamic securitisation, particularly high demand and tight pricing, the next few years are likely to see a surge of issuance with Islamic and non-Islamic borrowers looking to exploit a surplus of investment funds. ●

Malaysia leads the way

For an asset-backed securities (ABSs) market to be considered developed, it needs to show asset class diversity, investor sophistication and relative price competitiveness against alternative sources of funds. Using those criteria, Malaysia has the most advanced of any Islamic securitisation market.

Even though the Securities Commission, Malaysia's regulator, introduced its guidelines for ABSs in mid-2001, issuance – from both conventional and Islamic sectors – remained sluggish until late last year. Cagamas, Malaysia's government-controlled secondary mortgage agency, acted as a catalyst for both markets, when it issued an MYR1.6 billion ($421 million) mortgage-backed offering last October. Although not an Islamic deal, the pricing was significantly inside previous offerings, establishing a benchmark that made securitisation an attractive funding source to corporate borrowers.

Intriguingly, nearly all the deals issued since October (and all those to date in 2005) have been sukuk offerings. And, with it being such a new market, nearly all transactions completed recently have been a first in some way.

Property developer Talam Corporation set the ball rolling in February with an MYR150 million Islamic commercial mortgage-backed security transaction via Malaysian bank CIMB. Also that month, Pasir Gudang Local Authority securitised future property taxes in an MYR80 million deal. Not only was that deal a first in terms of asset and issuer type, it was also structured using mudharabah contracts, rather the more commonly used al-ijarah leasing notes. In mudharabah deals, investors provide the capital funding, while the issuer manages the assets. Profits are then distributed at a pre-agreed rate with losses borne solely by investors.

In April, Time Engineering, a provider of IT products and services, completed a MYR566.6 million offering, arranged by CIMB, which was backed by government payments on a contract, in which Time supplies computers and training to schools. This deal issued musyarakah-paper, where profits are again distributed at a pre-agreed ratio, but losses are shared according to the amount invested.

The pipeline of future issues is busier now than ever before. Deutsche Bank is readying a MYR160 million deal for plantation business, Multi-Vest Resources, while its rival, Boustead Holdings, has also announced Islamic securitisation plans.

Most recently, Cagamas tapped the market with the first Islamic mortgage-backed security in July. HSBC and CIMB arranged the MYR2.05 billion issue, which was 5.4 times oversubscribed. As most of the agency's new loan origination is in Islamic mortgages, it is likely that most of its future ABS issuance will also be in this sector. Malaysia's Islamic market can only benefit by having a regular government borrower for corporates to benchmark against.

Patrick Khoo, head of securitisation at CIMB, says the decision for issuers to go the Islamic route is a logical play. "Malaysia is an Islamic state and many Middle Eastern banks and investors have offices here," he explains. "Consequently, the Islamic banking sector is growing at an aggressive rate, with numerous Islamic bonds and structured deals being issued."

He adds that the sukuk market in Malaysia is attracting both Islamic and conventional investors. "From an issuer perspective, choosing this route actually broadens the spectrum of investors available to them," says Khoo. "Hopefully they can then get some pricing advantages over regular ABS from the increased level of demand, which is probably the case right now. There are also benefits for some investors in holding sukuk-compliant instruments – such as tax exemptions – so this is encouraging Islamic bond issuance in Malaysia."