

# **SUKUK**

## **Investment and Challenges**

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**ACADEMIC VISIT BY INCEIF'S CFP CANDIDATES**  
**30 October 2009**



## **Presentation Outline**

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- **Background**
- **Why Sukuk?**
- **Issuer due diligence – a critical investment process**
- **Challenges**
- **Conclusion**



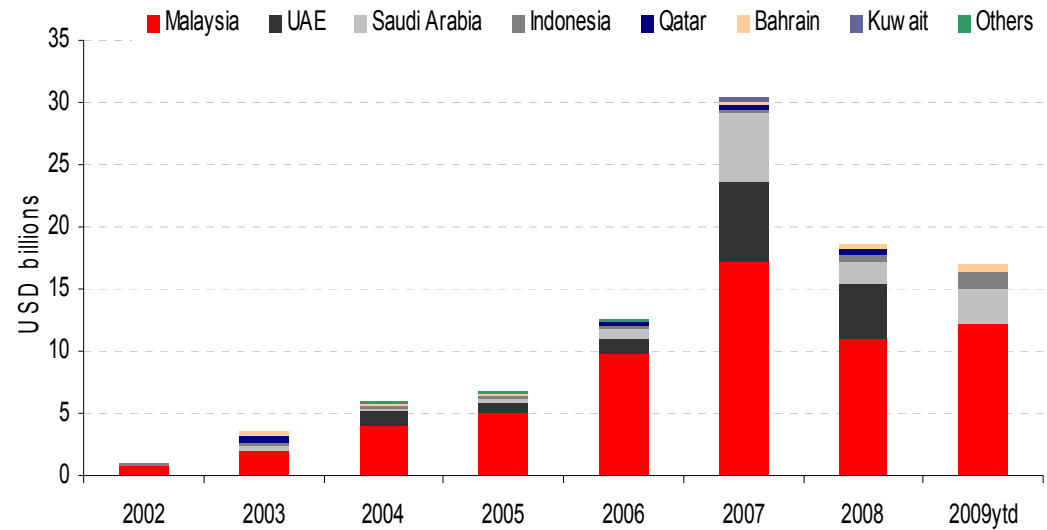
# Background

- Sukuk Investors are largely made of Commercial Banks (based on primary volumes.)
- Middle East, in particular the UAE has been the dominant source of issuance for USD Sukuks.

## Market Update

- Increasing appetite for risk in an improved economic conditions saw good demand for Sukuks this year.
- The issuance of Sukuk slumped in 2008 but seems to be revived this year.
- As liquidity is still flushed globally, we believe current condition will continue.

## Total Sukuk volume issued globally close to USD 100 bn.



Source : HSBC

## Order size for recent Sukuk issuances

Security	Issuer	Rtg	Spread vs UST 5 at issue	Issue size (USD bn.)	Order book (USD bn.)	Interest Gauge (x)
ISDB 5-year	ISLAMIC DEV. BANK	AAA	77.0	0.85	1.9	2
TDIC 5-year	ABU DHABI AGENCY	AA	266.0	1.00	6.78	7
CBBISC 5-year	CB OF BAHRAIN	A	340.0	0.75	3.98	5
RAK 5-year	UAE State	A	560.0	0.40	1.6	4
INDOIS 5-year	REP OF INDONESIA	BB-	705.3	0.65	4.8	7
DUBAI 5-year	State of Dubai	NR	406.0	1.25	4.9	4

Source : HSBC&SCB



# Background

## The GCC Market

- CDS spreads have tightened significantly but....
- due to concerns about refinancing risk in some countries in GCC, the markets had factored in a substantial risk premium, particularly in Dubai
- The positive global credit environment and improving local liquidity has lead to a continued rally in GCC credit spreads
- Cash has outperformed CDS on much greater volumes. CDS/ Cash traded volume ratio at 20% in 2009 versus historical average of 60%

### Sovereign CDS comps (as on 09/10)

#### Peer group by spread...

Country	Rtg	5yr CDS (mid)
<b>Dubai</b>	<b>NR *</b>	<b>295</b>
Lebanon	B2/B-	290
Estonia	A1/A-	220
<b>Egypt</b>	<b>Ba1/BB+</b>	<b>205</b>
Turkey	Ba3/ BB-	175
Panama	Ba1/ BB+	135
Peru	Ba1/ BBB-	122
Brazil	Baa3/BBB-	115
<b>Morocco</b>	<b>Ba1/ BB+</b>	<b>107</b>
<b>Abu Dhabi</b>	<b>Aa2/ AA</b>	<b>95</b>
<b>Qatar</b>	<b>Aa2/ AA-</b>	<b>84</b>
Thai	Baa1/BBB+	84
Malaysia	A3/A-	83
<b>Saudi Arabia</b>	<b>A1/AA-</b>	<b>75</b>
Czech	A1/A	71
Italy	Aa2/A+	68

\*Dubai is unrated, but Dubai Inc rtgs result in an implied rating in the A1/ A range



# Why Sukuk?

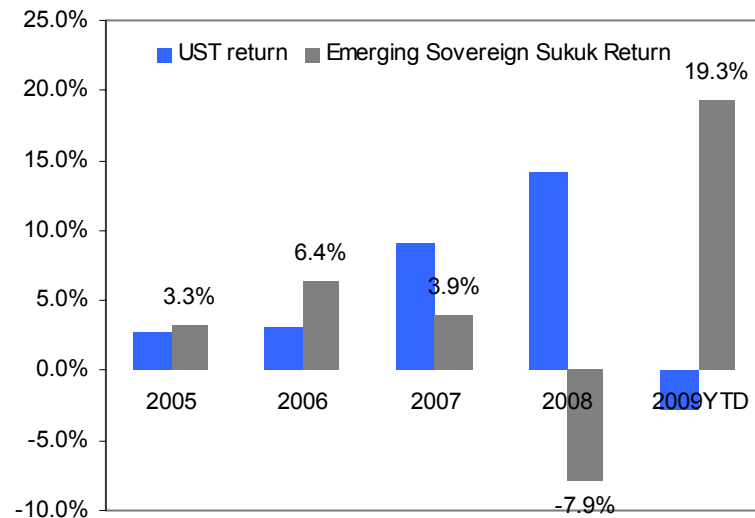
- Yield enhancement
- Asset class diversification
- Potential growth (strategic allocation)
- Familiarity
- Commitment to the development of Islamic Bond Market

## Attractive source of income above US Treasuries

Issuer	Rtg	Spread at issue (bps)	Current Spread (bps)	Performance (bps)
ABU DHABI AGENCY	AA	266.0	194.3	71.7
CB OF BAHRAIN	A	340.0	174.4	165.6
UAE State	A	560.0	336.2	223.8
REP OF INDONESIA	BB-	705.3	254.3	451.0
State of Dubai	NR	406.0	390.6	15.4

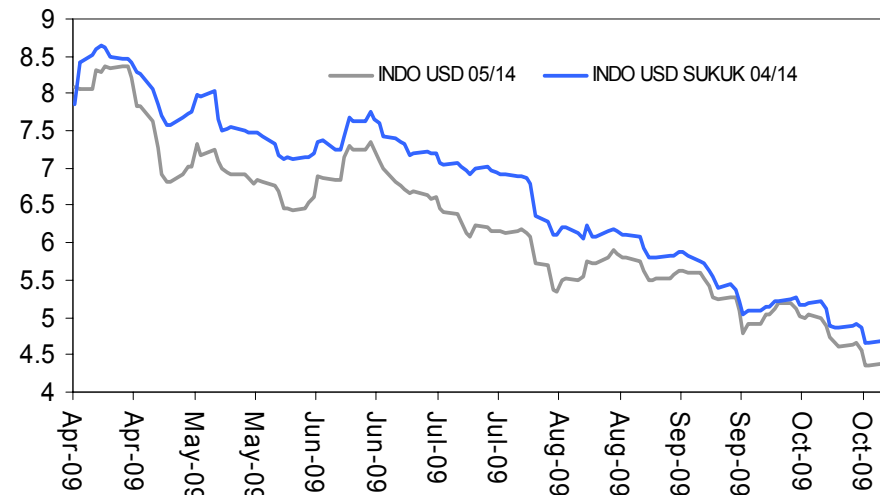
Source : Bloomberg

## Relatively better performance than UST...



Source : HSBC

## Slight premium for Sukuk in terms of pricing



Source : Bloomberg



# Issuer due diligence – a critical investment process

## Macro assessment

- Rating
- Economic Fundamentals
- Economic Policies
- Political Environment

## Micro assessment

- The cash flows of a Sukuk are similar to those of a conventional bond.
- Sukuk is treated as unsecured debt and therefore assessment on Sukuk focuses primarily on its structure (type) and credit risk of the issuer

## Comparison – conventional vs sukuk

	Conventional Bond	Sukuk
Senior Unsecured Debt	✓	✓ - Beneficial interest in assets can only be 'put' back to Obligor - Are not true sale securitisations and SPVs are not limited recourse or bankruptcy remote
Credit Risk – Risk of Obligor	<ul style="list-style-type: none"> <li>• Risk of Obligor</li> </ul>	<ul style="list-style-type: none"> <li>• Risk of Obligor</li> <li>- Provides Purchase Undertaking as Obligor and may also provide liquidity facility as Managing agent</li> </ul>
Terms and Conditions	<ul style="list-style-type: none"> <li>• As per normal commercial terms and indentures</li> </ul>	<ul style="list-style-type: none"> <li>• As per normal commercial terms and indentures</li> </ul>
Pricing	<ul style="list-style-type: none"> <li>• Driven by credit rating and book-building exercise</li> </ul>	<ul style="list-style-type: none"> <li>• Benchmarked to conventional pricing</li> </ul>
Investor Base	<ul style="list-style-type: none"> <li>• Conventional investors only</li> <li>• Excludes Islamic institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Potentially deeper pool inclusive of Islamic and conventional investors</li> <li>• Islamic investor base located primarily in Middle East and South East Asia</li> </ul>
Tenor	<ul style="list-style-type: none"> <li>• Short, Medium, and Long-term</li> </ul>	<ul style="list-style-type: none"> <li>• Short and Medium-Term</li> <li>• Typically 5 years</li> </ul>

Source : HSBC



# Challenges – Investing in Sukuk

- **Macro Risk Factors**

Political stability, economic fundamentals and policies may affect credit performance

- **Liquidity**

A captive market lead to a wide bid-offer spread

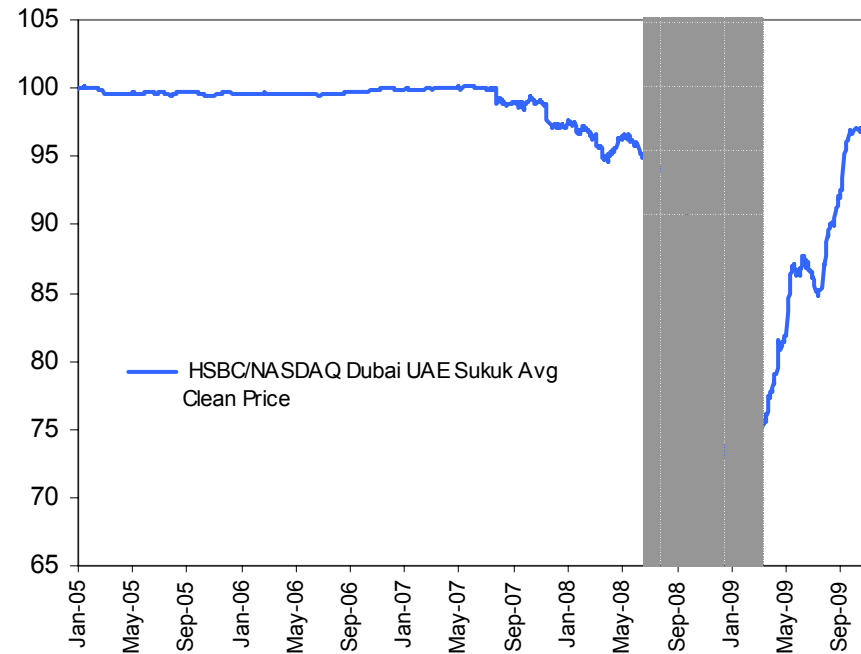
- **Price Volatility**

Absence of hedging instrument during risk aversion during crisis.

- **Data Availability & Timeliness**

The absence and timeliness of published data proved to be a significant challenge in order to make an informed decision.

## Flight to quality during Lehman fallout saw volatility in sukuk markets



Source : Bloomberg



# Challenges – Investing in Sukuk

Wide bid-offer spread in the sukuk market

<HELP> for explanation. Msg: SIMON QIU

DP WORLD SUKUK DPWORLD 1/4 07/17 95.7527 / 96.5027 (6.97 / 6.84) BGN MATRIX

Additional Providers Options DPWORLD 1/4 17 All Quotes 16:19:04

Buy Inquiry Sell Inquiry AXES BQ

CBBT SPREAD VS T 3 09/30/16 Govt @ 99-15 / 99-15<sup>3</sup>/<sub>4</sub> 3.086 / 3.082 386.4 / 369.5 bps

Abbr	Firm Name	Bid Price / Ask Price	Bid Yield / Ask Yield	Bid Sz x Ask Sz (M)	Time
CBBT	BONDTRADER COMPOSITE	95.875 / 96.875	6.950 / 6.777	1000 x 1000	16:18
RBOS	RBS FINANCIAL MKTS	95.750 / 96.750	6.972 / 6.798	500 x 500	16:18
NTAD	NATL BK OF ABU DHABI	94.902 / 96.402	7.121 / 6.858	x	15:58
FRNK	FRANKFURT EXCH	95.200 / 96.900	7.068 / 6.772	50 x 50	15:23
GERM	GERMAN EXCHANGE	95.200 / 96.900	7.068 / 6.772	50 x 50	15:23
SCLB	STANDARD CHART DUBAI	95.5000 / 96.5000	7.016 / 6.841	x	13:32
BPEX	BNP PARIBAS LONDON	95.900 / 96.600	6.946 / 6.824	x	13:00
BPGL	BNP PARIBAS LONDON	95.90 / 96.60	6.946 / 6.824	x	8:06
HSME	HSBC MIDDLE EAST	95.509 / 98.414	7.014 / 6.514	x	10/22/2009
NBDD	National Bank-Dubai	95.000 / 97.000	7.104 / 6.755	x	10/22/2009
BVAL	BVAL	95.731 /	6.975 /	x	10/22/2009
AUDB	BANQUE AUDI	95.50 / 96.50	7.016 / 6.841	x	10/20/2009

Firm Dealers Onl 
  Enabled Dealers Only 
  Executable Dealers Only 
 Firm / Enabled / Executable / Not Monitored / Best bid/ask

1st  2nd  3rd  4th  5th  Price Individually  No

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.  
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Source : Bloomberg





## Conclusion

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BNM is a long term unleveraged real money investor in which investments are strategic and long term in nature. Our investment approach is governed by three main principles, as follows

- a) Capital preservation**
- b) Sufficient liquidity**
- c) Optimal returns**

As a Central Bank, BNM seeks to avoid market disruption while at the same time supports the regulatory body's objectives in various markets.



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**Thank you**

