Demystifying the cost of funding for corporate Sukuk issuances

MOHAMMED KHNIFER provides an overview of how the Saudi banking industry has ignored the development of its internal Islamic debt market, resulting in the loss of the potential revenue.

Saudi Arabia has puzzled the Islamic finance industry for quite a while. We have been waiting for the 'sleeping Sukuk giant' for a decade now. In this article we attempt to demystify the evanescence of Saudi corporate Sukuk issuances as well as putting forward for the Saudi banks a new proposition for the upcoming and unforeseen Sukuk-generated fee-revenues.

For any sovereign or quasi-sovereign Sukuk issuance, the cost of funding is relatively cheap due to the solid creditworthiness of the obligor. However, this is not the case with the less savvy and low creditworthy corporate borrowers. Apparently, in this part of the world, these borrowers are for some reason labeled as 'unbankable'.

GCC bankers argue that the cost of funding and the interest rates associated with borrowing money are to blame for the dearth of corporate issuances.

How is this so?

For a number of reasons, there is a default premium risk attached to their issuance, resulting in higher yields paid to the Sukukholders. Given the stronger local liquidity conditions and the fact that the interest rate is at its lowest level, naturally the cost of funding for these borrowers will be lower if they turn to bank loans.

Abu Dhabi's Tourism Development & Investment Company and Dolphin Energy, as well as privately owned Dubai-based Majid Al Futtaim Group, have reportedly shelved plans to sell bonds this summer and tapped banks for at least some of their unmet funding needs.

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Now Saudi bankers are arguing that because of these conditions, Sukuk issuances are not appealing for corporate borrowers. In other words, borrowers will opt for Sukuk when interest rate rises. Only then will the cost of funding of Sukuk be attractive for them.

Even when that happens, the Saudi banks are relatively unprepared to acquire a share of this market. For some reason, Sukuk structuring and origination do not appear to be high on their priority list. If they do not act swiftly now, they will lose revenue to the universal banks in Dubai and Bahrain. Below is a Sukuk proposition to tackle this issue.

Saudi Arabia: 10 years = 21 corporate issuances

The below table showcases a comparison of corporate Sukuk issuances over the past 10 years between Saudi and Malaysia.

Over the past 10 years, Malaysia has issued 952 corporate Sukuk (worth US$49.8 trillion), compared with Saudi Arabia which has issued 21 corporate Sukuk (worth US$14.2 trillion).

Remember that there is no comparison between the size of Malaysia's economy and that of Saudi Arabia. With the Saudi government now opening up the biggest stock market in the Arab region and planning to spend US$400 billion on its infrastructure, there are plenty of deals to chase in the kingdom, which also benefits from high oil prices.

The road map of recovery

Having been able to issue only 21 corporate Sukuk in the past 10 years suggests that the Saudi banks have significantly miscalculated the importance of this niche market. One must question how a smaller economy like Malaysia has managed to boost the corporate market and come up with 952 issuances over the same period. Below are some key points and recommendations for the Saudi banking industry:

1) The Malaysian investment banks have successfully created demand for what seems to be an unbankable market

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Table 1

	Corporate Sukuk	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Jan - Aug 2011	Total	Pipeline
Malaysia	Size of Issues ($ mil)	1,613	277	3,677	2,080	5,715	3,888	15,793	4,358	2,368	6,727	3,387	49,884	3,253
	Number of Issues	31	18	25	84	136	86	86	81	75	190	140	952	24
Saudi Arabia	Size of Issues ($ mil)				26		818	5,716	1,873	2,260	2,503	1,013	14,210	2,284
	Number of Issues				1		2	5	4	3	3	3	21	7

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from the Saudi banks' perspective. This includes bringing to the market sub-investment grade issuance, creating what is better known as the 'Sukuk junk' market. In fact, one Malaysian bank now specializes in these small size issuances, which has contributed to its position as one of the world's top five Sukuk arrangers.

2) The above data shows the spectacular miscalculation of the market potential for corporate Sukuk Saudi issuances by the Saudi banking sector. If the Saudi banks had the right Sukuk infrastructure, they could have expedited the awakening of corporate issuances. Remember they have already lost revenues to universal banks that could have been theirs. Although any sovereign Sukuk issuance is now being outsourced to Dubai or Bahrain, HSBC Saudi Arabia has dominated the Sukuk market, followed by Samab Capital and Saudi Hollandi Bank. Al-Rajhi has the potential to excel in this area, and certainly can do much better.

3) The current argument by Saudi bankers (that it is 'not economically viable' to specialize in Sukuk origination and structuring because one established investment bank currently dominates the domestic market) is not true. We have seen from the Malaysian example how the domestic banks created a junk Sukuk market despite stiff competition for sovereign and quasi-sovereign Sukuk.

4) It is not too late to start building up proper infrastructure for highly skilled Sukuk teams, as the Saudi corporate Sukuk market is still in its infancy.

5) If we want to expedite the awakening of the Saudi corporate Sukuk market, we need to:

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a) Educate corporate clients about the full potential of Sukuk in terms of capital structure. One of the ways of doing that is through (Islamic finance) relationship managers who can bring mandates to the table. The current level of corporate Sukuk usage is quite low. For instance, when I was explaining an innovative 'clustered' Sukuk structure to a seasoned banker, his response was that my thinking was 'quite advanced' for their corporate clients.

b) Have proper regulatory Sukuk guidelines.

c) Have a comprehensive legal infrastructure in place, in particular regarding the ownership rights of foreigners.

6) During this transition process, many indigenous Islamic finance GCC talents will fade away if they are not given the opportunity to be part of Sukuk structuring teams which have been and still currently are a 'restricted' area for them. This impression was created by the first generation of GCC Islamic bankers, who saturated the market with conventional types of banking, resulting in the poor track record of Sukuk structuring in the country. With the exception of perhaps Bahrain, we have not heard of any young GCC Islamic bankers who have specialized or have been given the chance to be part of an Islamic debt team. If these talents do not have the support of their domestic banks, then we should not expect the universal banks to do so either.

Saudi banks are losing revenues that they could have earned if they had properly invested in setting up a proactive and comprehensive Sukuk infrastructure. As a result, universal banks are taking advantage of this gap in the market. Domestic banks need to act swiftly, otherwise they will be mere bystanders when the corporate Sukuk market in Saudi Arabia finally explodes.

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