ISLAMIC BONDS IN FINANCIAL CRISIS

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Abstract

The financial crisis in 2008 is widely viewed as the most serious since the Great Depression. Facing a severe market reaction to the failure of AIG and Lehman Brothers, the US treasury Department put forward a bold and massive program of spending up to $700 billion on purchasing "troubled assets' from financial institutions. The financial institutions need a finance product that which could decrease the risk borne by financial crisis.
The *Sukuk* (Islamic Bonds) products are asset-backed, stable income, tradable and Syariah compatible trust certificates. Having *Sukuk* in the portfolio diversifies the holdings which could decrease the risk borne by the financial institutions.
The first finding of this research, since Islamic bonds are more stable than conventional bonds and are less affected by the crisis hence many countries (whether Moslem or non Moslem countries) start to prepare to use Islamic bond system. The second finding is Malaysia become the largest *Sukuk* issuer by three reason, *first* is The Malaysian government fully support for Islamic financial system, especially for *Sukuk*, *second* is *Sukuk* in Malaysia have high rating provided by RAM ratings' so both Muslim and non Muslim investors would like to invest in this market and *third* is Malaysia has a good relationship with Islamic Investor (which prefer to choose Islamic bonds)

The current financial crisis is widely viewed as the most serious since the Great Depression. Facing a severe market reaction to the failure of AIG and Lehman Brothers, the US treasury Department put forward a bold and massive program of spending up to $700 billion on purchasing "troubled assets' from financial institutions. (Lucian A. Bebchuk,2008). If you cannot qualify for loans or having difficulty obtaining credit through the normal channel, then a subprime loan may be your next port of call. Sub-prime loans (or housing loans) are risky as they are given to people with unstable incomes or low creditworthiness. The interest rate on a subprime loan is likely to be higher than an interest rate you would expect on a loan from a bank.

In the United States, the government policies and competitive pressures for several years prior to the crisis encouraged higher risk lending practices. Further, an increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices had encouraged borrowers to take loans to finance their own house. However, once interest rates began to rise and housing prices started to drop moderately in 2006–2007 in many parts of the U.S., refinancing became more difficult. (http://en.wikipedia.org/wiki/Subprime_mortgage_crisis-cite_note-publications1-2#cite_note-publications1-2).

Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to go up as anticipated. As the US housing bubble burst, borrowers began to default on their mortgages. Major Banks and other financial institutions around the world have reported losses of approximately US$540 billion as of September 2008, and this has continued to increase. Despite concerted efforts by governments and central banks worldwide to cut interest rates and inject massive liquidity into the stock market and the banking system, the global crisis has yet to show any sign of abating. Countries are already experiencing recession while the more resilient economies are revising their economic growth downwards. Such as the Asian financial crisis has not only reduced foreign investment in the transition economies of Southeast Asia, but has also impacted on the domestic financial structure with associated implications for strategy and marketing. (William, Anthony, and Esta, 2001)

Islamic Bond Market

Islamic Securities (*Sukuk*) is one of the fastest growing tools in the Islamic Capital Market that triggered the desire of supply and demand from Muslim and Non-Muslim from all in the world. The advantage of *Sukuk* is that they are compliant with Shariah Islamic Law (Wilson, 2008). *Sukuk* (Arabic: صكوك, plural of صك Sakk, "legal instrument, deed, check") is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed income, interest bearing bonds are not permissible in Islam, hence *Sukuk* are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets. (Umar Mohamad Idris 2008)

The *Sukuk* products are asset-backed, stable income, tradable and Syariah compatible trust certificates. The primary condition of issuance of *Sukuk* is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institutions or any entity which wants to mobilize the financial resources. The identification of suitable assets is the first and arguably most integral step in the process of issuing *Sukuk* certificates. The Shariah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts.

The *Sukuk* market has expanded dramatically over the recent past and continues to generate strong interest by new issuers in Muslim and non-Muslim countries alike Given the existing intensity of investor interest in Shariah-compliant assets, the potential of *Sukuk* is likely to strengthen, especially given increasing opportunities from financial innovation. While the continuous growth of overall *Sukuk* issuance is expected to be somewhat depressed in response to the fallout of the US sub-prime markets crisis and the legal uncertainty surrounding the recent AAOIFI (Accounting and Auditing Organization for Islamic Financial Institution) ruling on *Sukuk*, sovereign *Sukuk* in particular are likely to gain popularity as more governments in both Muslim and non-Muslim countries explore options to diversify their traditional debt portfolios. The latest examples of this trend are efforts in the UK, Japan, and Thailand to establish a *Sukuk* issuance program and Indonesia’s bill on Islamic debt financing (April 2008), which will enable the government to fund large parts of its budget deficit by issuing *Sukuk*. (Andreas, Peter, Paul and Amadou, 2008)

Market of *Sukuk* in the Global Aspects

The market for *Sukuk* issues have been largely confined to the Gulf countries and Malaysia, with the latter accounting for the overwhelming number of issues, although the amounts are significant in the Gulf where the average size of each issue tends to be larger (Wilson, 2008). The market for *Sukuk* has injected a much-needed scope for liquidity management in Islamic banks. Such liquidity could only be secured through continuous Murabahah transactions. In a global market where conventional finance dominates, liquidity could only be acquired by transactions limited to specific Shariah acceptable commodities such as industrial goods, metals and oils. The process of issuing *Sukuk* certificates allows Islamic financial institutions to garner a much wider asset pool that were previously either inaccessible or inefficient.

Islamic financial services organizations generate higher profits from loyal customers, and committed customers tend to be more satisfied with their banking relationship (Jain et al., 1987; Kimbell, 1990) which is commitment can lead to technical bonds, planning bonds, knowledge bonds, social bonds and legal bonds between banks and customers who invest with them (Homlund and Kock, 1996).

Developments of *Sukuk* Markets

Global

The issuance of *Sukuk* certificates must be unequivocally linked to one or more underlying assets. These assets, in turn, are typically transferred to a special purpose vehicle (SPV) for a period equal to the maturity of the *Sukuk*. Although there is no explicit legal restriction on the creation of SPVs, Kuwait does not posses an unambiguous framework for the establishment, management, and accounting procedures of these vehicles. The absence of a predictable set of rules introduces a serious element of uncertainty in *Sukuk* transactions, and thus severely limits the attractiveness of these Islamic instruments.(Juan Sole, 2008)

In the Gulf countries most issues are in US dollars, against which these currencies are pegged, although there is the possibility that with the introduction of a new unified currency for the Gulf Co-operation Council countries in 2010 the link with the US dollar may be replaced by a trade weighted basket. This could result in the new Gulf currency becoming the denominator of choice for *Sukuk* issuance. (Rodney Wilson, 2008)

The period from January to September 2005, and since then there have been some very large issues in the Gulf, notably the $1 billion issues for the Civil Aviation authority of Dubai to fund the new terminal at the international airport, and the issuance of the largest ever Islamic *Sukuk* security offering valued at $2.8 billion. This offer is by the Ports, Customs and Free Zone Corporation of Dubai, the holding company of Dubai Ports World and the Jebel Ali Duty Free Zone. This interest-free financing, which complies with Islamic shariah law, is being handled by the Dubai Islamic Bank, the oldest Islamic commercial bank in the world and the third largest. The *Sukuk* will pay 250-350 basis points over LIBOR, a very attractive rate providing a projected yield of 7.25-8.25 per cent, and is convertible after two years into shares, the first ever Islamic securities structure of this type. (Rodney Wilson, 2008)

Malaysia

Malaysia has become the frontrunner for the development of Islamic capital markets since the 1980s. The country now accounts for about two-thirds of the global Islamic securities outstanding and represents the largest *Sukuk* market in terms of outstanding size and number of issues, estimated at US$47 billion at end-2006. While *Sukuk* account for 14 percent of Malaysian public sector bonds outstanding, they represent about half of the total stock of Malaysian corporate bonds (US$32 billion). Corporate *Sukuk* are issued mainly by the infrastructure/utilities and property/real estate sectors (70 percent). (Andreas, Peter, Paul and Amadou, 2008)

Then Malaysia pioneered the development of the global *Sukuk* market with the launch of the first sovereign five year global *Sukuk* in 2002. After the first *Sukuk* issue in 2002, Islamic finance came into its own in October 2004, after Cagamas Berhad, the National Mortgage Corporation of Malaysia, issued a RM1.6 billion (US$432 million) conventional MBS to create a (liquid) yield curve for securitized debt with longer maturities. (Andreas, Peter, Paul and Amadou,2008)

Since then Malaysia's *Sukuk* market has experienced unprecedented growth, and it has been acknowledged as one of the largest issuers of *Sukuk* over the years. In 2007, 76% of bonds approved by the SC were *Sukuk*. Challenging market conditions this year has naturally had an impact on the issuance of bonds but nonetheless, the first nine months saw the approval of 36 *Sukuk* issues for amount RM24.6 billion, accounting for 27.3% of total bonds approved during the period. There are several reasons why *Sukuk* issuances from Malaysia, whether denominated in ringgit or US dollar, will continue to attract international investors and issuers. First, Malaysia has a strong base of domestic investors to anchor the distribution of a major *Sukuk* issue. Second, *Sukuk* pricing for Malaysian-originated issues are highly competitive and there is also strong availability of expertise as well as an established regulatory framework which meets both Shariah and legal requirements. (Source http://www.sc.com.my)

Impact between Islamic Countries and Malaysia

Impact to the GCC

The Gulf Co-operation Council (GCC) was not spared the spill-over of the sub-prime crisis. The impact of the sub-prime crisis on Islamic finance has become more obvious by the day. The problem however was not from sub-prime loans, although the GCC sovereign funds have stakes in several of the troubled banks in the US and Europe. Instead the causes were a combination of effects from the decline in world oil prices and property bubble burst.

In anticipation of the local currencies appreciating against the US dollar, investors in the GCC began withdrawing funds when instead the dollar appreciated thus causing further liquidity problems among the banks. It was reported that one central bank in a GCC country has intervened to rescue a bank. The banking authorities in various GCC countries have begun pumping in cash to ensure the banks can meet liquidity requirements.

Beside the positive aspects derived from deeper local financial markets, Kuwait would also benefit from the emergence of large and dynamic regional bond and *Sukuk* markets. In such regional markets, governments and companies from across the region would be able to attract a wide pool of institutional investors, not only from neighboring countries, but also from other parts of the world. (Juan 2008). Kuwait needs to deepen further its financial markets in order to expand the range of financing opportunities for the private sector. Upgrading the country’s financial system should be one of the main ingredients in the authorities’ overall strategy for diversifying the Kuwaiti economy away from oil activities. Furthermore, a more diversified financial system would facilitate the financing of the upcoming large infrastructure projects. The Kuwaiti authorities should strive to enhance the legislative and institutional environment to support the development of the corporate bond and *Sukuk* markets. (Juan 2008)

Impact to Malaysia's Islamic finance industry

The Malaysian Institute of Economic Research (MIER) has revised its growth forecast for 2009 to 3.4% from its earlier forecast of 5%. The government has introduced a multi-pronged economic stabilization package aimed at mitigating a sharp slowdown in domestic demand given the substantial weak external environment. The contraction is expected to hurt banks' income and Islamic financial institutions will not be spared.

Bursa Malaysia lost 40% of its value as at 31 October 2008. Shariah-compliant stocks (SCS) also took a beating. The impact on the Islamic indices, in most cases, was less severe compared to the overall index because finance counters, being the most adversely affected were precluded from SCS. However, in some cases the off-set effects were the absence of non-SCS but defensive large market capital stocks such as tobacco, gaming and brewery companies. The value of *Sukuk* approved in 2008 was US$ 5,470.40 million, down from US$ 13,412.90 million at end–2007. In the near future, it is expected that prospective issuers may reconsider issuing *Sukuk* as they face higher yields, and the fact that the economic slowdown would require them to reexamine their financing requirements.

Comparative of *Sukuk* Issuance during Financial Crisis

In the year 2008, ten countries had *Sukuk* issuance, of which half were from the GCC countries. The composition of issuing countries was the same in 2007, except for Gambia which replaced Sudan. All countries experienced a fall in *Sukuk* issuance in terms of dollar amount in 2008 except for Qatar and Indonesia. The largest drop in *Sukuk* issuance was recorded by Kuwait that witnessed a decline by 77.2% from US$835mn, followed by Saudi Arabia only country to experience a major increase in *Sukuk* issuance was with a fall of 67.2% from US$5.7bn in 2007. The Indonesia issues with more than a six folds increase over 2007 (US$92.8mn), while Qatar maintained almost the same level.

Minister of Finance of the Republic of Indonesia said that the Indonesian Sharia-based financial market is still early stage of development so is still lack in supply and the government does not have a strong legal basis for issuing *Sukuk* in her speech at International Workshop on *Sukuk* organized by the International Islamic Financial Market on 12th September 2006. In the year 2008, Malaysia was the largest market for *Sukuk* raising US$5.5bn from 54 issues; average issue raised US$101.3mn. UAE was the second largest market raising US$5.3bn from 10 issues; average issue size was US$530mn.

One of UAE Bank which is HSBC has reward 'as Best International Provider of Islamic Financial Services and Best International *Sukuk* House in Euro money's 2003 Islamic Finance Awards. (Dr. Marwan Mohamed Abdeldayem 2009) Even though these reward in 2003 but its show that UAE is one of country which has issuance *Sukuk* in these past years. Saudi Arabia was the only country to join the billion dollar *Sukuk* club, along with UAE and Malaysia, raising US$1.9bn from 4 issues and averaging US$468.3mn per issue. The amount of *Sukuk* issuance in Gambia was the lowest in 2008 (US$12.6mn), despite it had a high a number of issues of 40. Other countries include Bahrain (US$700mn), Indonesia (US$663mn), Pakistan (US$476mn), Qatar (US$300.9mn), Kuwait (US$190mn), and Brunei (US$95mn).

Distribution of *Sukuk* Issues By Country ($US Billion)

The Islamic bond market is still concentrated in the GCC region and Malaysia, in terms of dollar amount. GCC countries accounted for 55.5% of the dollar amount issued, while Malaysia accounted for 36.3%. Corporate *Sukuk* issues amounted to US$13.3bn, or 88.5% of the total dollar amount, while sovereign *Sukuk* were worth US$1.7bn, or 11.5% in the same period. In the year 2008, Malaysia was the largest market for *Sukuk* raising

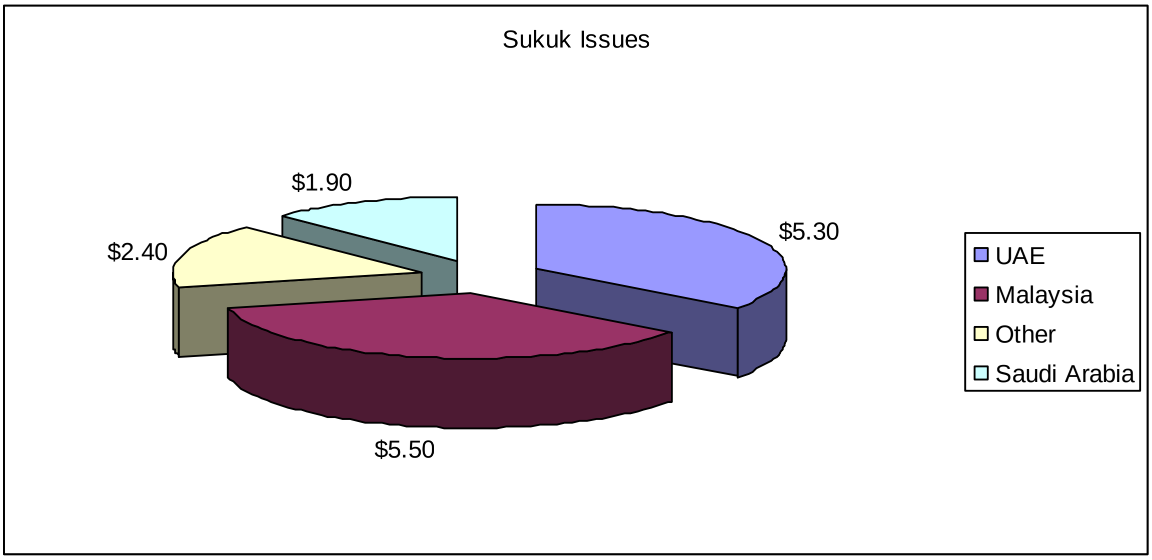
US$5.5bn from 54 issues. UAE was the second largest market raising US$5.3bn from 10 issues.

Table 1

Country	***Sukuk* Issues**
UAE	$ 5.30
Malaysia	$ 5.50
Other	$ 2.40
Saudi Arabia	$ 1.90

Source : Global Investment House – February 2009

Figure 1



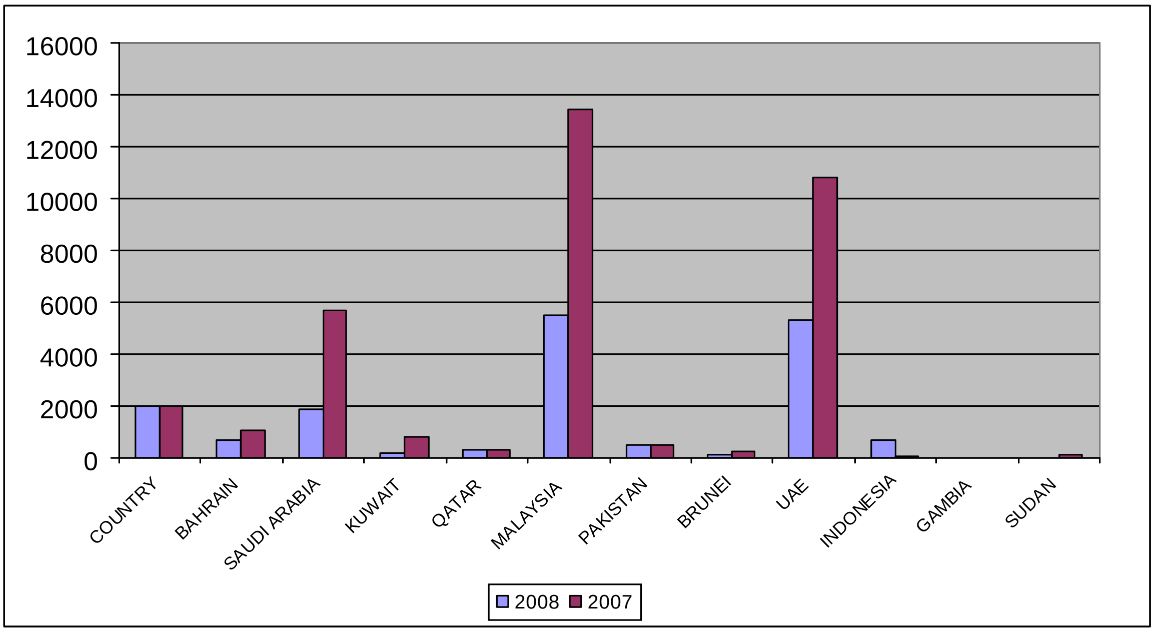
a) *Sukuk* Issuance by Country ($US Million)

Table 2

COUNTRY	**2008**	**2007**
BAHRAIN	$ 700.40	$ 1,065.00
SAUDI ARABIA	$ 1,873.20	$ 5,716.30
KUWAIT	$ 190.00	$ 835.00
QATAR	$ 300.90	$ 300.00
MALAYSIA	$ 5,470.40	$ 13,412.90
PAKISTAN	$ 476.20	$ 524.30
BRUNEI	$ 95.10	$ 279.30
UAE	$ 5,300.20	$ 10,807.50
INDONESIA	$ 663.30	$ 92.80
GAMBIA	$ 12.60	$ -
SUDAN	$ -	$ 130.00

Source : Global Investment House – February 2009

Figure 2



Sukuk Issuance By Region

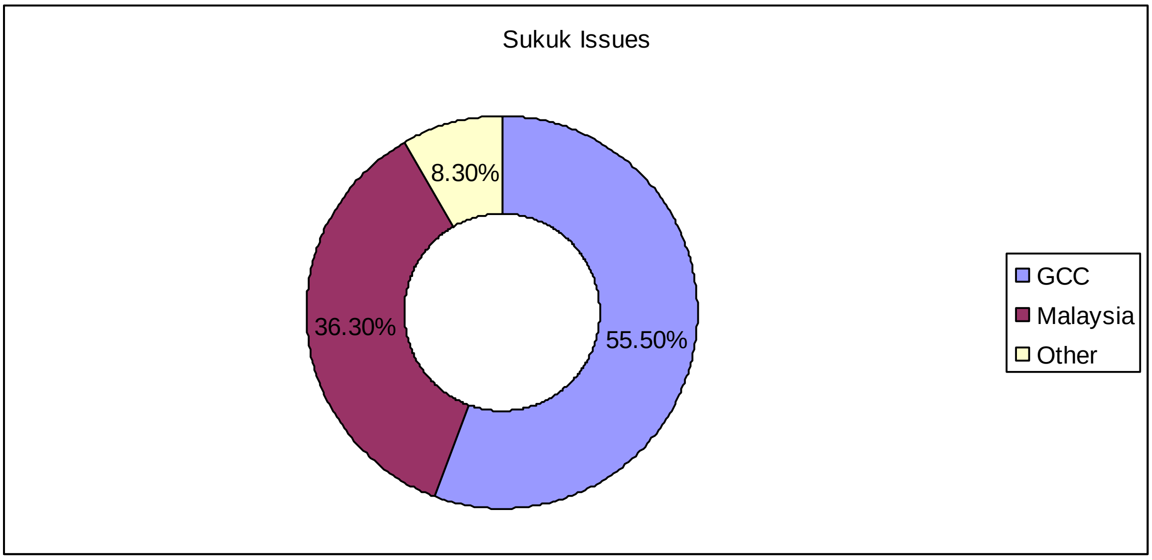
The Islamic bond market is still concentrated in the GCC region and Malaysia, in terms of dollar amount. GCC countries accounted for 55.5% of the dollar amount issued, while Malaysia accounted for 36.3%. Meanwhile, the number of *Sukuk* issued by corporate slightly decreased from 97 in 2007 to reach 92, while the number of sovereign *Sukuk* increased by more than double to reach 73 in 2008 from 32 in 2007.

Table 3

Country	**_Sukuk_ Issues**
GCC	55.50%
Malaysia	36.30%
Other	8.30%

Source : Global Investment House – February 2009

Figure 3



Global *Sukuk* Issuance

Islamic financial industry has been gaining popularity in recent years. Around 300 financial institutions are working according to Islamic principles and they are scattered over 75 countries. Currently, GCC and Malaysia are the main centers for the Islamic industry. Excluding 2008, the Islamic financing industry had been growing at a double digit over the last ten years. It is estimated that the Islamic financing assets are worth up to US$700bn. Part of this massive expansion of this market is due to the boom of the GCC economies. In addition, the industry had been witnessing a wide spread acceptance among Muslims, and non-Muslims alike. Nevertheless, the industry is still in its infancy, when compared to the total global financial sector.

With the recent crisis in the financial industry, voices calling to rely more on the Islamic principles are rising. Islamic financial institutions were impacted less than conventional institutions. The lesser impact was due to the restrictions that Islamic laws place on financial transactions. The toxic assets, which include mortgage backed securities (MBS) and credit default swap (CDS), are impressible in Shariah. The year 2008 witnessed a decline in the amount of *Sukuk* issuance, after years of massive growth. The amount raise from issuance decreased by 54.5% in 2008 to US$15.1bn, as compared to US$33.1bn in 2007. Despite that, the number of global *Sukuk* issues increased from 129 in 2007 to reach 165 in 2008.

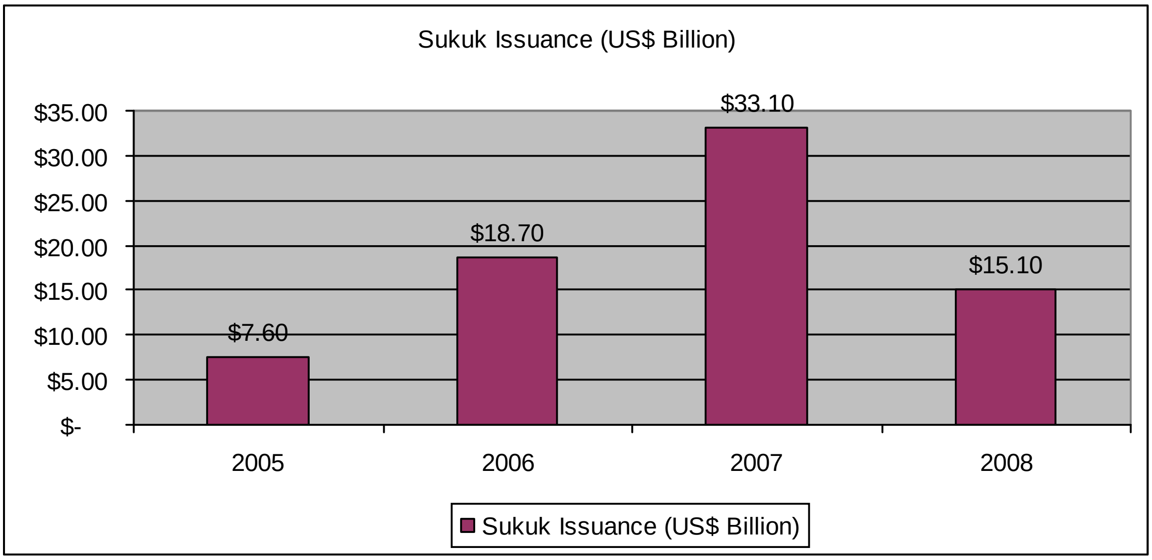
The decline in *Sukuk* issuance is due to the credit crunch that forced investors to step aside from the fixed income market, including the Islamic one. As evident of the credit crunch effect on *Sukuk*, issuances in the fourth quarter of 2008 were weak when compared with other quarters in the same year. In the first three quarters of last year, the number of *Sukuk* issuances was 139 raising US$14.3bn, averaging US$4.8bn per quarter. On the other hand, the number of *Sukuk* issuance in the fourth quarter of 2008 was 26, raising US$0.8bn.

Table 4

Year	***Sukuk* Issuance (US$ Billion)**
2005	$ 7.60
2006	$ 18.70
2007	$ 33.10
2008	$ 15.10

Source : Global Investment House – February 2009

Figure 4



Sukuk Issuance by Structure ($US Million)

Sukuk structure comes in a variety of flavors. Most importantly, all these structures must conform to the Islamic principles, and the degree of popularity of any structure depends on its usability, and credibility. Many structures could be similar, but practitioners avoid the complex one. In addition, issuers always seek the less controversial structure, in order to attract as many investors as possible. The creditability of a structure plays a vital role because vast majority of prospective buyers of *Sukuk* are interested in its compliance with Shariah.

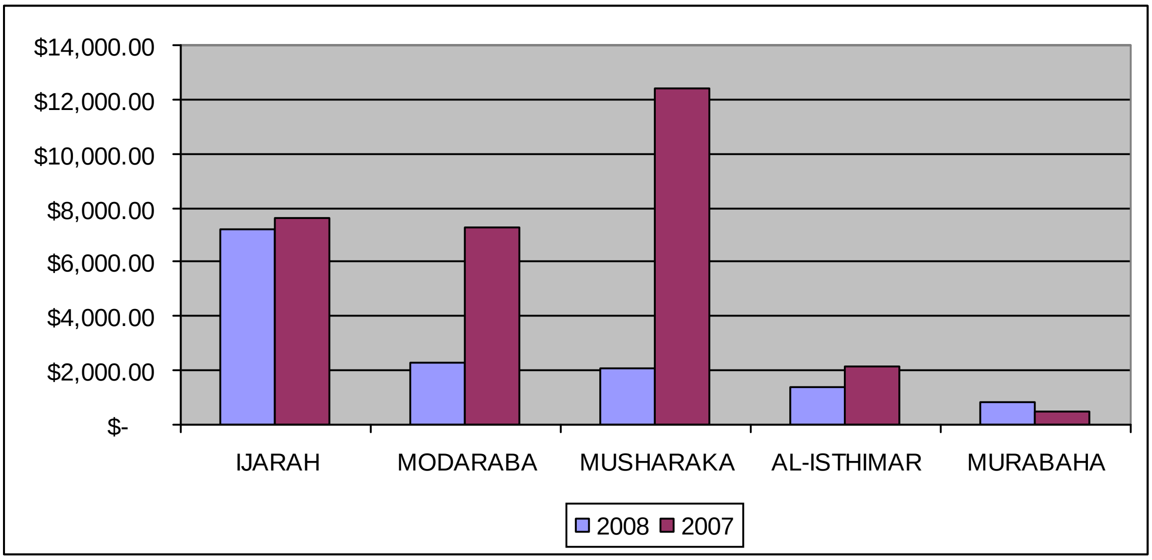
In 2008, there were 5 structures whose market share of the total dollar amount exceeded 90%, and they were Ijara, Modaraba, Musharaka, Al-Isthimar, Murabaha. Of these structures, only Murabaha witnessed growth by 59.3% from its level of US$512.3mn in 2007 to reach US$816mn in 2008. Musharaka structure was the highest in 2007 with US$12.4bn worth of *Sukuk* issued, but it fell by more than 83% to reach US$2.1bn in 2008 to become the third ranking structure in terms of dollar amount. Other structures declines include Modarabah (68.6%), Al-Isthimar (34.4%), and Ijara (5.5%).

Table 5

STRUCTURE	2008	2007
IJARAH	$7,176.30	$ 7,590.40
MODARABA	$2,278.40	$ 7,266.30
MUSHARAKA	$2,105.40	$12,430.70
AL-ISTHIMAR	$1,399.90	$ 2,133.10
MURABAHA	$ 816.00	$ 512.30

Source : Global Investment House – February 2009

Figure 5



The Attractiveness of *Sukuk*

Sukuk become a *new idol* in bond markets around the world. It shows by many countries (whether Moslem or non Moslem countries) start to prepare to use Islamic bond system. Such as: Singapore, China, Japan, United Kingdom, United State of America, Germany, Morocco, Kenya, Both Korea, etc. Many western countries have shown interest in the Islamic industry, as a way to complement their financial system. For example, there are plans for sovereign *Sukuk* issuance in some western countries, such as, UK and Germany. Besides, UK, in its efforts to become a hub, is under way to issue a law governing *Sukuk*.

> "The investor that ready to allocate certain amount of funds in the bonds of a certain issuer, diversification by including *Sukuk* in the investment portfolio could significantly reduce the portfolio's VaR compared to a strategy of investing only in conventional bonds of that issuer".

VaR measures the worst expected loss of a portfolio over a certain holding period at a given confidence level, under normal market conditions (Jorion 2006). In other words, VaR is an expression of the portfolio's market risk, representing the maximum amount which may be lost, during a holding period, in all but (say) one percent of cases. (Cakir and Raei 2007).

CONCLUSION

Malaysia is the largest *Sukuk* issuer country in the world : (a) The Malaysian government fully support for Islamic financial system, especially for *Sukuk*. (b) *Sukuk* in Malaysia have high rating provided by RAM ratings' so both Muslim and non Muslim investors would like to invest in this market. (c) Malaysia has a good relationship with Islamic Investor (which prefer to choose Islamic bonds), such as: Malaysia Airlines System (MAS) is the only one Airplane Company besides Saudi Arabia Airline that allowed entering Mecca.

Sukuk become a *new idol* in bond markets around the world. It shows by many countries (whether Moslem or non Moslem countries) start to prepare to use Islamic bond system. Such as: Singapore, China, Japan, United Kingdom, United State of America, Germany, Morocco, Kenya, Both Korea, etc. *Sukuk* become an alternative for portfolio diversification, the current credit crunch proved that Islamic finances can provide alternative products other than conventional sources of financing. Having *Sukuk* in the portfolio diversifies the holdings which could decrease the risk borne by the financial institutions.

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