



25th June 2008

2008 London Sukuk Summit

**The Royal Horseguards, Whitehall
London**

**Leveraging Opportunities in the Secondary Market - Potential for
Sukuk, Securitization & Intermediation**

**Presentation by: Lawrence Oliver, Director
DDCAP Limited**

Leveraging Opportunities in the Secondary Market

Islamic Financial Marketplace

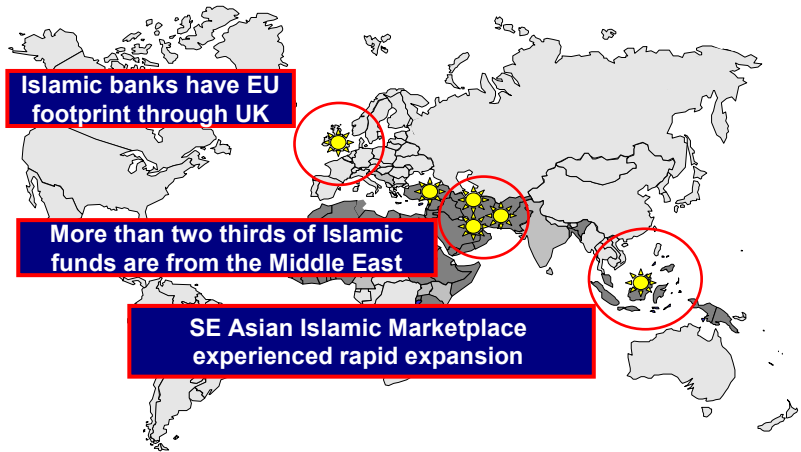
- **The contemporary Islamic financial sector was pioneered by several, super high net-worth individuals in the early 1970s**
- **Today there are more than 350 established Islamic banks and financial institutions and many conventional banks with Islamic "windows" divisions, or subsidiaries**
- **Financial assets within the sector are estimated at US\$ 500bn *1**
- **Liquid Funds in the Islamic marketplace looking for quality assets are circa US\$ 50bn *2**

(sources: – *1 World Bank 2007 / *2 UAE MOF)



Leveraging Opportunities in the Secondary Market

Islamic Financial Marketplace – Sources of Funds



- 1.3 billion Muslims (20% of population)
- Fastest growing and one of the most active religions



Leveraging Opportunities in the Secondary Market

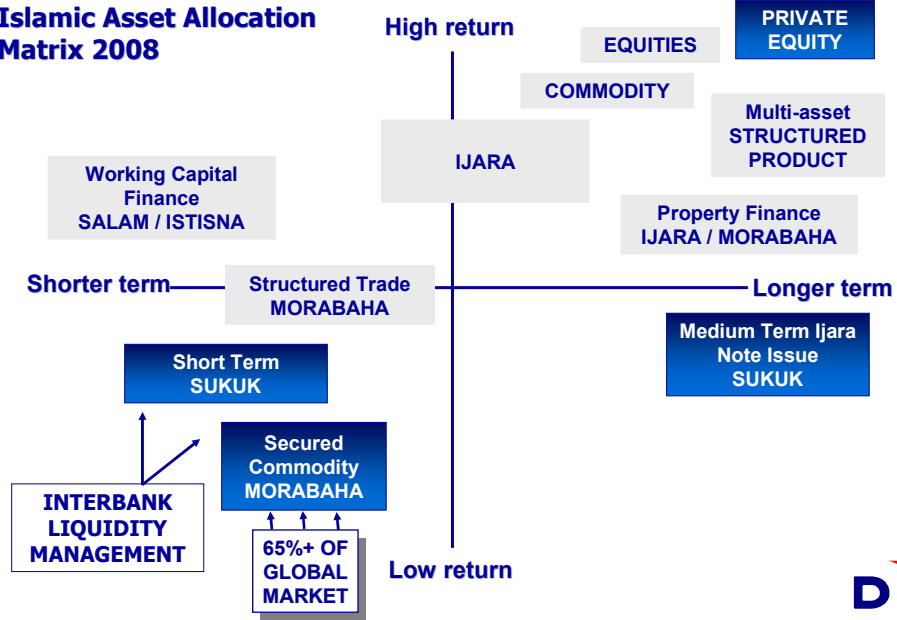
Evolution of Islamic Finance Product Timeline

- Since the mid 1970s Islamic finance has followed in the wake of innovations in the global financial services industry
- Shift from simple commercial banking products to more sophisticated ones with longer tenors
- Developing Capital Markets in parallel with Islamic market infrastructure



Leveraging Opportunities in the Secondary Market

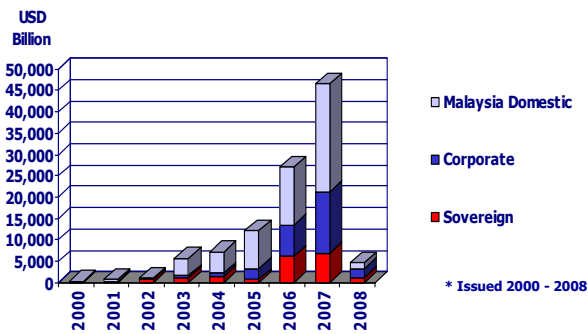
Islamic Asset Allocation Matrix 2008



Leveraging Opportunities in the Secondary Market

Islamic Capital Markets – 2000/2008

- Sukuk were first recognised as a Sharia'a compliant instrument in Malaysia c. 2000
- Total issues to March 2008 approx. US\$ 105 billion *
 - US\$ 56.5 (436 issues) Malaysian domestic
 - US\$ 26.3 (213 issues) international corporate
 - US\$ 22.3 Sovereign (domestic and international)



(*source – IFIS)

Leveraging Opportunities in the Secondary Market

Sukuk structures 2000 - 2008

- Sukuk are issued through various structures
- Although initially many issues were Ijara based, 2007 saw a focus on Musharaka
- There were also several Murabaha issues
- AAOIFI has, to date, issued 14 structural standards although following their Sharia'a challenge at the end of 2007, AAOIFI have subsequently issued new guidelines in March 2008



Leveraging Opportunities in the Secondary Market

Sukuk structures 2000 - 2008

Sukuk structure	No. of issues
International corporate issues 2000 – 2006	
Islamic Exchangeable	1
Al Musharakah	2
Murabahah	2
Ijara	13
Other	12
International corporate issues 2007	
Bai' Bithaman Ajil	1
Investment Sukuk	1
Islamic Exchangeable Bond	3
Mudharabah	4
Sukuk Al Ijara	6
Sukuk Al Musharakah	12
Sukuk Al-Manfa'a	1
Sukuk (other)	28
International corporate issues 2008	
Bai' Bithaman Ajil	15
Islamic Exchangeable Bond	2
Istisna'a	1
Mudharabah	4
Murabahah	9
Sukuk Al Ijara	16
Sukuk Al Musharakah	25
Sukuk (other)	3

Leveraging Opportunities in the Secondary Market

Why Sukuk?

- Between 65% - 80% of the assets of Islamic banks have historically been overweight in non-tradable short-term investments, such as Morabaha
- Created inappropriate concentrations, adversely impacted yields and portfolio/balance sheet diversification
- Also, inefficient for supporting reciprocal liquidity requirements as Sharia'a stipulates contract may not be traded *
- Islamic banks remain hungry for risk asset diversification and instruments better suited to liquidity management purposes

(* note: Malaysia permits trading of Morabaha)



Leveraging Opportunities in the Secondary Market

Development of Secondary Trading

- Development of Sukuk secondary trading is viewed as essential to inject liquidity
- To date this has been slow to happen
- Most Sukuk have been purchased to hold
- Investors have no incentive to trade because:-
 - There is insufficient depth of quality new issues
 - Historically Islamic sovereign issues have offered enhanced yields
 - Simply a lack of more attractive assets to replace existing holdings
 - Information flows are limited
 - Participants lack confidence in market infrastructure
- 2007 liquidity crunch and recent AAOIFI Sharia'a challenge have had an impact on both pricing and access



Leveraging Opportunities in the Secondary Market

Capital Market Infrastructure Requirements:

- **Standard or consistent market practice:**
 - product origination – market standards
 - trade contracts – standard documents
 - pricing – benchmarks, ratings
 - settlement – crossborder, secure payment mechanisms
- **Authoritative regulation, market best practice**
- **Established, tested legal infrastructure**
- **Efficient processes and systems**
- **Confidence – issuers, investors, participants, intermediaries**
- **Liquidity through volume and market utilisation**



Leveraging Opportunities in the Secondary Market

Motivating Secondary Trading

Development of Clearing and Settlement for Secondary Trading

- **Sukuk are traded over a number of different manual and automated systems**
- **Malaysia managed over 0.5 million secondary bond trades OTC in 2006 without the benefit of an electronic system but technology can support efficiency and cost reduction**
- **Settlement varies although the global, listed Sukuk are settled through Euroclear and Clearstream, which develops market confidence**
- **Otherwise, average time to process a Sukuk trade from deal to settlement is more than a day**



Leveraging Opportunities in the Secondary Market

Motivating Secondary Trading

Measuring Performance - Sukuk Issuance Information

- Listing:** Nearly all sovereign issues have been listed in Luxembourg and subsequently regionally dual listed (Labuan, Dubai, Bahrain)
First London Stock Exchange US\$1bn + corporate issue listed in March 2007
However 66% of issues outstanding are unlisted
- Maturities:** Ranging from 3 months to ten years, with most somewhere midway
- Price basis:** Sovereign – majority have been floating, apart from Bahrain's
Corporate – over 50% floating and various mechanisms utilised to fix the remainder
- Ratings:** Sovereign issues – majority rated by S&P and dual rated by Moody's / Fitch. Other agencies such as Capital Intelligence and MARC have also rated issues
S&P had rated US\$12bn in listed Sukuk outstanding as at September 2007 *

(*source – S&P Outlook 2008)



Leveraging Opportunities in the Secondary Market

Motivating Secondary Trading

Measuring Performance - Sukuk Indices

- Previously missing from the market until the Dow Jones Citigroup Sukuk index launched in April 2006
- DIFX HSBC Sukuk index launched in October 2007
- Established to provide benchmark for investors seeking exposure to Sharia'a compliant fixed-income investments

Benchmark Criteria

	Dow Jones Citigroup
Currency:	US Dollar
Issuance:	Global
Compliance:	Sharia'a endorsed and compliant with AAOIFI standards
Maturity:	1 year minimum
Issue Size:	US\$ 250mn minimum
Rating:	At least BBB- / Baa3 explicit or implicit by leading international agency

	DIFX HSBC
Currency:	US Dollar / EURO / GBP / JPY
Issuance:	Global
Compliance:	Considered Sharia'a compliant by at least one Middle Eastern based Scholar
Maturity:	1 year minimum
Issue Size:	US\$ 100mn minimum
Rating:	No restrictions



Leveraging Opportunities in the Secondary Market

Motivating Secondary Trading

How do we educate the market?

- Issuers, investors and intermediaries - how do they participate?
- Role for a professional market body – IFSB, IIFM (ISDA, ICMA)?
- Early 2007 saw high global demand from all investors for Islamic capital market products, underpinning market liquidity
- 2008 illiquidity, credit and structural issues have impacted investor confidence
- Investors need to be informed, structures need to be appropriate (i.e. Ijara – Musharaka – Next?)



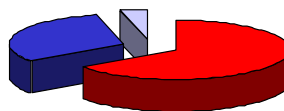
Leveraging Opportunities in the Secondary Market

The Opportunities - Market Trends 2008 - Bonds

- Total GCC bond issuance 2007 reached US\$ 47.7bn
- UAE (particularly Dubai) accounted for 65% of total, Saudi Arabia 30%
- Softening of markets in Quarter 4 and estimate US\$ 10billion in delayed transactions
- Total GCC corporate bond issuance for 2007 totalled US\$23.7bn up US\$11.7bn, approx. 50% were Sukuk *
- Issuance of corporate bonds by the GCC has potential of US\$50 billion for 2008 *
- Corporate and sovereign demand for inward investment, infrastructure
- Markets are still volatile; Investor comfort is key

GCC bond issuance 2007

- UAE
- Saudi Arabia
- Other



(sources – * Moody's Investor Service)



Leveraging Opportunities in the Secondary Market

Summary

- Markets and investors are becoming more sophisticated using cash as a strategic liquidity management tool
- Islamic banks liquidity management needs should remain the driving force but conventional bank liquidity needs will feature
 - Basle I caused Sukuk to be a capital intensive asset for banks
 - Basle II provisions in 2007 are expected to improve this
 - Ratings are also important
- Market needs continual issuance, supported by Sovereigns, rather than 'landmarks'
- Greater volume of fixed rate issues will introduce new, longer-term investors such as pension funds, with criteria on changes to market forecast, credit and yield
- Exchangeable/convertible structures in GCC securities have been in demand and listing on international stock exchanges (e.g. LSE – March 2007) has introduced another new investor class
- Liquidity, credit crunch and structural issues will dominate short-term

