

Portfolio diversification with Sukuk

Authors:
 Laura Slater,
 Shamaila Khan,
 and EM Fixed Income
 Team

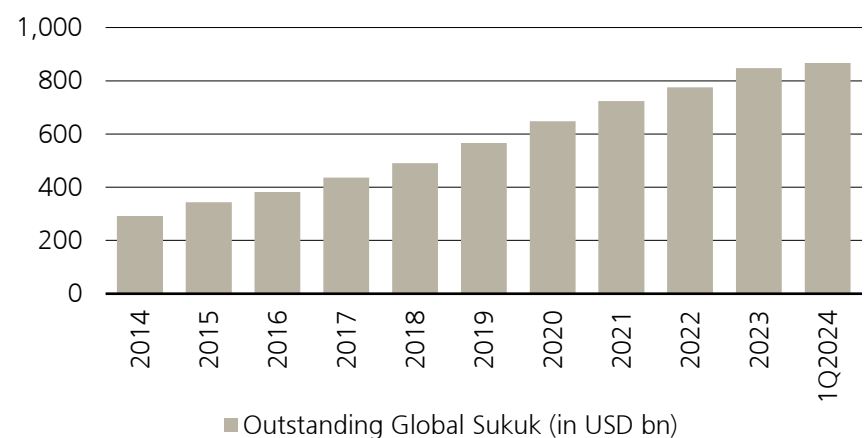
Sukuk, often referred to as Islamic bonds, are financial instruments that comply with Islamic law also known as Shariah. Unlike conventional bonds, which involve interest payments on a loan, Sukuk represent ownership in tangible assets, services, or an investment in a particular project or business venture. Shariah prohibits interest, excessive uncertainty and speculation and disallows investments in industries such as alcohol, pork production and gambling.

As of Q1-2024, the global Sukuk market is around USD 867 billion in size with almost three-quarters of outstanding instruments denominated in local currencies and the rest in US dollars. Dollar-denominated sukuk are typically structured as trust certificates under English law. The hard-currency international sukuk market is the real attraction and driver of the increased interest in the asset class from an asset allocation perspective.

Asset class with secular growth

The first Sukuk transactions date back to the 7th century AD in Damascus, Syria. More recently, in early 2000, the Malaysian government issued the first modern Sukuk bond marking the start of what would become a rapidly expanding market. Sukuk issuance has since gained global traction, with notable issuances from the United Arab Emirates, Saudi Arabia, and even non-Muslim majority countries like the United Kingdom and Luxembourg. This global expansion reflects the growing acceptance and integration of Sukuk into the international financial system.

Figure 1: Sukuk are a meaningful asset class



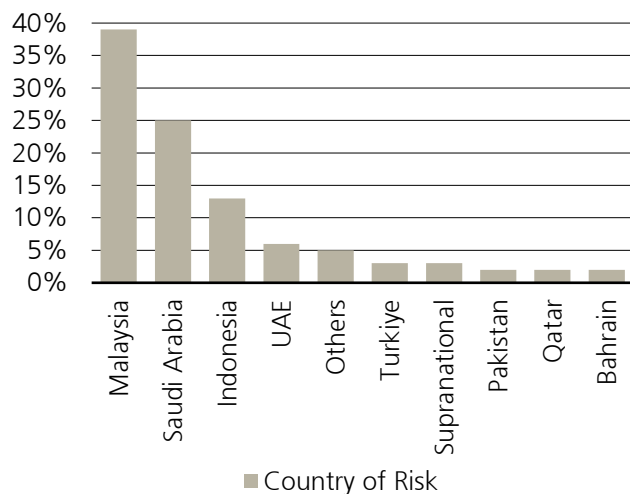
Source: Fitch as of March 2024

Over the past decade, the Sukuk bond market has thus metamorphosed from a niche market into a more mainstream asset class, as shown in Figure 1. This growth has been characterized by increasing diversification in terms of geographical issuance and industry sectors. The investment universe now includes sovereign, quasi-sovereign, and corporate issuers, with a notable increase in participation from non-Muslim majority countries. This expansion has been driven by a growing demand for Sharia-compliant investment products and the increasing attractiveness of Sukuk as stable and ethical investment options.

As indicated below in Figure 2, Malaysia remains the largest Sukuk market globally, with around 60% of its local currency debt market in Sukuk, while Gulf Cooperation Council (GCC) countries account for 35% of global outstanding Sukuk. The GCC is an expanding issuer region due to the vast number of infrastructure projects.

Sukuk issuance especially for sovereigns are often heavily oversubscribed. Egypt's debut USD 1.5 billion Sukuk attracted bids of more than USD 6 billion in 2023. Pakistan's 2022 Sukuk was oversubscribed by more than two times.

Figure 2: Outstanding Sukuk by country of risk



Source: Fitch Ratings and Bloomberg, March 2024

Sukuk and conventional bonds

When comparing Sukuk bonds to conventional bonds, several distinctions emerge. Sukuk attract a diverse range of investors, including both conventional and Islamic investors. They appeal particularly to those looking for ethical investment options and those adhering to Islamic principles.

In terms of pricing new issues, Sukuk bonds are influenced by similar factors as conventional bonds, such as credit risk, duration, country of risk and prevailing market conditions. However, some Sukuk bonds have historically traded at a premium due to their Sharia-compliant nature and the limited supply relative to demand. Many Sukuk issuers have cross default provisions with their other debt obligations

which ensures that Sukuk are ranked pari-passu with conventional bonds.

Liquidity is another area where Sukuk bonds have traditionally differed from conventional bonds. Historically, Sukuk bonds have been less liquid in the secondary trading market due to a higher proportion of bonds being held by buy-and-hold style investors. However, this landscape is changing with increasing issuance and growing familiarity among investors, which is gradually enhancing their liquidity profile.

Recent developments

In recent years, sustainable and green Sukuk issuances have grown substantially, aligning with global trends towards sustainable investing.

These instruments are designed to fund projects with environmental or social benefits, such as renewable energy or social infrastructure projects. The first green Sukuk was issued by Malaysia in 2017 and, since then, green Sukuk have gained popularity, with several countries and corporations following suit. Not only do they comply with Islamic Law, but they also meet international standards for green finance, thereby attracting a new and broader range of investor class interested in sustainable and ethical investment options.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recently completed market consultation on its proposed AAOIFI Sharia Standard 62. The proposed standard in its current form implies a shift from an asset-based sukuk structure, which is equivalent to senior unsecured conventional bonds, to an asset-backed sukuk structure, which is similar to a securitization. Market implications will largely depend on what form the finalized standard will take, which Islamic finance countries will adopt it, and how they will implement it.

Looking ahead, the future of the Sukuk bond market looks appealing. Continued growth in market size is expected and forecasted to cross USD 1 trillion in the medium term. Such growth will likely be driven by the increasing demand for Sharia-compliant products and broader global acceptance.

As the market matures and more participants enter the secondary market, liquidity is also expected to increase. The ongoing development of sustainable and green Sukuk bonds is expected to further enhance the depth and breadth of the market, contributing to its evolution as a significant asset class.

Myriad of benefits

From an investment perspective, allocating to Sukuk bonds offers several compelling benefits. Firstly, Sukuk bonds have historically provided stable returns with low volatility thereby making them appealing on a risk-reward basis. Secondly, they offer risk mitigation benefits, as Sukuk bonds often exhibit low correlation with conventional bonds, thereby enhancing portfolio diversification. Lastly, they provide an avenue for ethical investing, aligning with the principles of ethical and socially responsible investing.

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