Zeti Akhtar Aziz: Sukuk development and financial stability

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at 10th World Islamic Economic Forum (WIEF) "Sukuk Development and Financial Stability", Dubai, 28 October 2014.

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It is my great pleasure to be here in Dubai at this World Islamic Economic Forum 2014 to speak at this dialogue session on the potential of the sukuk market and its role in the economic development process and in contributing towards financial stability. This recent decade has witnessed the accelerated development of the global sukuk market. The global sukuk market which has now reached USD$270 billion outstanding is evolving to become a distinct platform for fostering greater international economic and financial linkages. The success of the sukuk market reflects its ability to meet the changing and differentiated demands of the modern economy, to develop innovative and cutting edge structures and products, and to achieve such issuances at competitive pricing.

The sukuk market has drawn increasing interest from sovereigns, multilateral institutions, multinational and national corporations both from developed and emerging economies to finance investments in a wide range of economic activities and development projects. The geographical reach of the sukuk market has also become more extensive, with the global sukuk outstanding now being domiciled in more than 20 countries, while the investor base that spans from Asia, the Middle East and Europe. In addition to issuances in international reserve currencies that includes the US Dollar, the British Pound and Euro, more recently in Malaysia has been the issuance of sukuk in Renminbi.

For the investors, the sukuk offers the diversification into multiple asset classes and different techniques used to structure medium to long term instruments. Given that the sukuk is based on underlying assets, it discourages over-exposure of the financing beyond the value of the underlying assets. Issuers are thus discouraged from leveraging in excess of the asset value. The prospect of over-indebtedness and its consequences on financial stability are thus reduced. There is also potential for direct participation of investors in the project, thereby granting investors beneficial ownership in the underlying assets, with the rights to receive a share of profits or rental income from the underlying asset of the sukuk while taking the associated risk of such ownership.

The sovereign sukuk is generally the first inroad into Shariah compliant funding in the capital market, enabling the creation of reference prices over time, to which private sector entities can benchmark their fund raising activities. Governments have for the most part, remained the most active issuers in the history of the global sukuk market with sovereign issuances accounting for more than 80 percent of the global sukuk issuances. This recent few years has also seen a number of jurisdictions in developed economies strengthening their legal, regulatory and governance framework to facilitate such sukuk issuances.

Going forward, the financing requirements for economic development are envisaged to be massive, particularly for emerging and developing economies in the Asian and Middle Eastern regions that are seeking huge amounts of capital to fund new infrastructure and to support economic development. Given the sheer size of these projects, equity and government budgets cannot be the only source of financing for this next phase of economic growth and industrialisation in our regions. The sukuk market has become a potentially important new source of funding for such long term projects. In the recent decade, a total of US$95 billion of infrastructure sukuk has been issued by more than 10 different countries. In Asia, it is estimated that a funding of US$8.3 trillion is required until 2020 for infrastructure projects, while the funding requirements in the Middle East are estimated to be US$2 trillion over the same period. Developing economies in Africa have also already begun its entry into the sukuk market for such infrastructure financing with some having put in place the legal groundwork for such sukuk issuances.

However, low sovereign ratings have limited the ability of certain high-growth developing countries to source such funding, despite being rich in natural resources. Countries that are rich in natural resources may however, pledge these resources for such issuance. Funding may thus be secured arising from the securitisation of such assets. Given the recourse to the asset by investors, it provides the incentive for disciplined and appropriate governance of the management of the project. Additionally, multilateral development banks may also facilitate this process by providing credit guarantees to these countries to reduce the financing cost and improve the quality of the sukuk issuances. On this front, multilateral development banks such as The Islamic Development Bank (IDB) Group and The Asian Development Bank (ADB) commenced initiatives to support member countries to leverage on Islamic finance for sourcing of funds, through the provision of advisory services, capacity development and technical assistance.

Allow me to now share Malaysia's experience in the development of the sukuk market in our Islamic finance marketplace. The Islamic capital market in Malaysia has been systematically developed to ensure accessibility whilst ensuring the protection of investors and efficiency in the intermediation process. The initiatives to develop the market are also strongly backed by the legal and Shariah framework which is further supported by a robust financial infrastructure, including the settlement and bond information system that enables Malaysia to provide a complete sukuk issuance and trading platform.

Since the first sukuk issuance in 1990 by a multinational corporation in Malaysia, the sukuk outstanding in the Malaysian marketplace is now US$158 billion. In 2002, the Malaysian government issued its inaugural global sovereign sukuk, raising US$600 million, which became an international benchmark for the issuance of global sovereign sukuk. The marketplace has now been liberalised to allow for multilateral financial institutions, multinational and national corporations from other jurisdictions to issue both ringgit and non-ringgit denominated sukuk in our sukuk market with increasing foreign investor participation in such issuances

The sukuk market in Malaysia has seen wide ranging innovative structures and a greater diversity in the type and maturity of the sukuk. A landmark issuance is the US$750 million exchangeable sukuk *Musyarakah* in 2006 by Khazanah, the government's investment corporation for the purpose of selling a stake in Telekom Malaysia. It marked the first issuance of its kind, incorporating full convertibility features common to conventional equity-linked transactions. A further notable issuance was the pioneering retail exchange-traded sukuk to raise funds for a transportation project that allowed retail investors the opportunity to have direct access to the sukuk and thus a stake in a massive infrastructure development in the country, therefore broadening the range of low-risk investment products available to such investors. In terms of maturity, the ringgit sukuk market has seen issuances of maturities to 30 years which were well received by the financial market. Regular sukuk issuances with different maturities by the Malaysian government has also created a benchmark yield curve for market reference, of which is complimented by the establishment of a number of indices for non-ringgit and ringgit denominated sukuk that serve as benchmarks to track the performance of sukuk. These initiatives have progressively contributed towards creating a vibrant secondary sukuk market in Malaysia, with increased depth and liquidity.

In complementing the sukuk market as a source for fund raising, also being explored are other funding channels to assist small and medium enterprises, new growth industries and entrepreneurs that have limited access to the sukuk market. A multi-bank investment platform is now being developed for the effective matching of funds from potential investors with targeted industries and ventures in the real sector. Foreign Islamic financial institutions and investors also stand to benefit from this platform, with the offering of multi-currency financing options for foreign projects. The platform facilitates Islamic banks to perform investment intermediation functions. It enhances further the intermediation role of the Islamic banking institutions to also function as an investment intermediary.

In an increasingly internationalised global financial marketplace that has generated significant cross-border flows, one of the requirements as we advance forward is the need for more tradeable cross-border Islamic financial instruments that can cater to the different profiling of investors' risk appetites. The issuance of the short-term sukuk by the International Islamic Liquidity Management Corporation (IILM) is a breakthrough in innovation towards increasing cross-border liquidity flows that could potentially enhance financial stability and the efficient functioning of the Islamic financial markets.

Let me conclude my remarks. There is clear indication of the growing relevance and importance of the sukuk market, with the growing interest from both emerging and developed jurisdictions and the strategic approaches taken to diversify the funding sources through the sukuk market. The overall direction and potential of the global sukuk market are certainly well recognised, particularly in its role in contributing towards greater economic development. There is significant potential for the sukuk, in particular to fund infrastructure projects. This is particularly relevant for the GCC, African and Asian regions given the infrastructure needs going forward. This would contribute towards building deeper and more liquid, efficient and effective global sukuk market. The dynamism of the sukuk market also contributes towards strengthening financial stability and in facilitating the expansion of inter-regional investment flows. As we move towards increasing this internationalisation of Islamic finance, and thus towards greater global financial integration, it will contribute towards a global growth process and financial stability that will be mutually reinforcing.