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Global Sukuk Market Outlook: Another Strong Performance In 2018?

Primary Credit Analyst:
Mohamed Damak, Dubai (971) 4-372-7153; mohamed.damak@spglobal.com

Secondary Credit Analysts:
Emmanuel F Volland, Paris (33) 1-4420-6696; emmanuel.volland@spglobal.com
Christian Esters, CFA, Dubai (971) 4-372-7169; christian.esters@spglobal.com

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After a strong performance last year, it's unclear whether the global sukuk market can stage a repeat performance in 2018. Sukuk issuance in 2017 increased by 45.3%, reaching $97.9 billion, up from $67.4 billion in 2016, underpinned primarily by the jumbo issuances of some Gulf Cooperation Council (GCC) countries. Driving this performance, S&P Global Ratings believes, were good liquidity conditions in the GCC and, more generally, globally, as well as activity by some countries with the goal of further developing their Islamic finance industries. What's more, some issuers (particularly in Saudi Arabia), in our view, were able to choose sukuk over bonds because they were less pressed for time to raise funds. By comparison, the outlook for sukuk in 2018 looks uncertain. While we still foresee significant financing needs for core Islamic finance countries, tighter global liquidity conditions, mounting geopolitical risks, and slow progress on the standardization of Islamic finance products will continue to hold the market back from its full potential.

Overview

- Sukuk issuance volume increased significantly to $97.9 billion in 2017, thanks to jumbo issuances by some GCC countries.
- The outlook for the market in 2018 looks uncertain, and we expect issuance volumes to hover at $70 billion-$80 billion.
- We note slow progress in the standardization of sukuk products, but greater awareness of the need for increased standardization.

Demand Is Likely To Soften: Here's Why

Jumbo local and foreign currency issuance by some GCC countries drove the sukuk market higher in 2017 (see charts 1 and 2). Of specific note, the $9 billion sukuk issued by Saudi Arabia was the largest issued globally to date. The market also continued to attract some Islamic finance noncore countries, with Hong Kong tapping the market for the third time and the first issuance of a sukuk in Nigeria. We expect this trend to continue as Morocco and Tunisia plan to tap the market in 2018 and the U.K. announced its intention to go to the market again in 2019 upon the maturity of the sukuk it issued in 2014. While we believe the financing needs of some Islamic finance core countries will remain high, we expect that total issuance will likely decline to $70 billion-$80 billion in 2018.

Chart 1

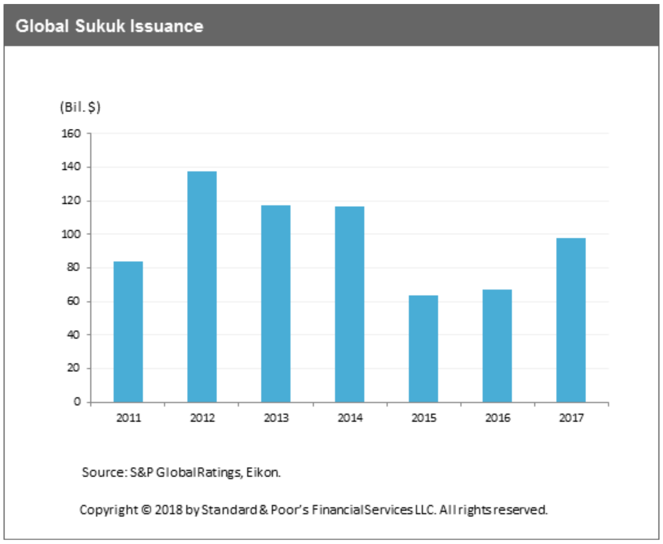
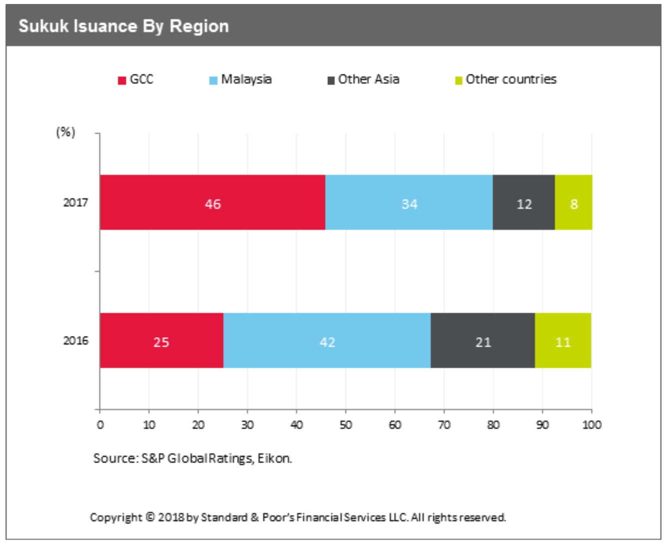


Chart 2



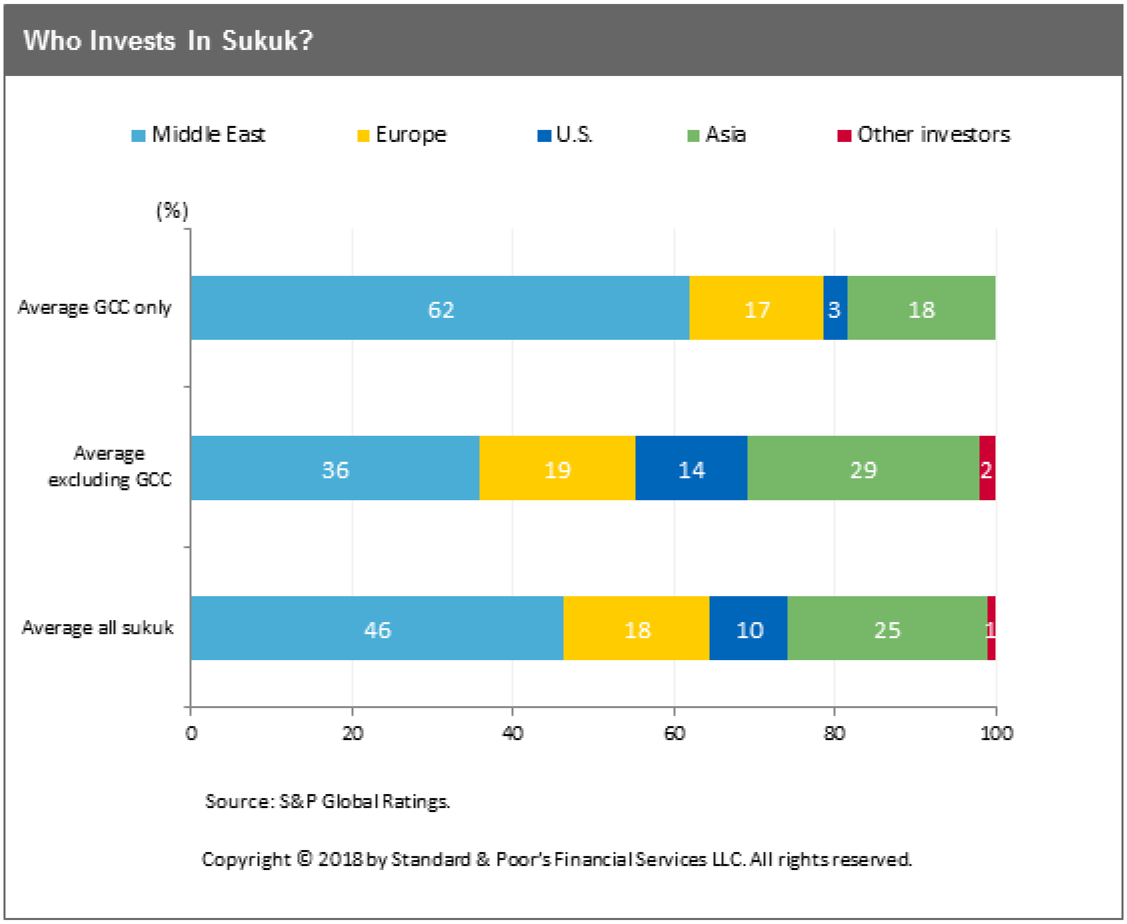
There are three main reasons for our expectation:

Global liquidity is likely to tighten

While global liquidity remained abundant in 2017, we expect some tightening in 2018. For example, we expect the federal funds rate to increase by 75 basis points. Central banks in the GCC countries will probably mirror such an increase due to the peg of their currencies with the U.S. dollar. In the same vein, the European Central Bank has announced it will start reducing the pace of its asset purchases from January 2018, to €30 billion a month from €60 billion. It will likely end its program only in 2019 and start to raise rates by then. Overall, we think that the cost of funding for issuers will rise and that liquidity from developed markets channeled to the sukuk market will reduce or become more expensive.

Liquidity conditions in GCC countries improved last year. The increase in oil prices, which we now expect to remain at about $55 per barrel, helped. At the same time, muted economic growth and declining lending activity shifted banks' focus from lending to capital market activities where they sought higher yields than for cash and money market instruments. However, the recent resurgence in geopolitical risk in the region might worry regional and international investors. Investors based in Europe and the U.S. accounted for about 28% of sukuk primary investors for the sample of international sukuk that we looked at (see chart 3). The sample included 34 international sukuk issued in 2014-2017 for a total of $27.7 billion and for which the distribution of the investor base was publicly available.

Chart 3



Geopolitical risk is on the rise

We believe that geopolitical risk considerations are weighing heavier on the minds of some investors. Sanctions imposed on Qatar in early June 2017, by a group of Arab states, resulted in funding outflows from the country's banking system that we estimate at $21 billion as of Sept. 30, 2017. We expect these outflows to continue as foreign deposits mature but the pace to slow. We view the government's injection of funds ($39 billion over the same period) as a strong mitigating factor. However, the boycott changed investors' perception of the cohesiveness of GCC countries as a block. Similarly, investors may look unfavorably upon recent shifts in Saudi Arabia's power structure and societal norms, which could increase the risk of policy mistakes. However, we also consider that these structural reforms could empower Saudi citizens and make the Kingdom more attractive to investors over the medium term, as the authorities intend. The continued animosity between Iran and the GCC countries is not helping the investment climate either.

The standardization agenda is progressing slowly

Standard-setting bodies have expended a significant amount of energy in advancing the standardization agenda, but we are not there yet. The Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) and the Islamic Financial Service Board (IFSB) issued several new standards in 2017 aimed ultimately at smoothing the process of sukuk issuance. For example, the former published a standard for central sharia boards and the latter published one on disclosure requirements for sukuk.

Some market participants still think that standardization is unrealistic and that the market should rather aim for harmonization--defined as having standards that may differ from one jurisdiction to another, leaving some flexibility for implementation. This we see as the status quo. Cases similar to Dana Gas, where the issuer upset the market by declaring its own sukuk as noncompliant with Sharia, are bound to renew the standardization debate. We are of the view that standardization for cross-broader sukuk issuance is not only achievable, but will boost issuance volumes, and restore the attractiveness of the instrument to issuers through a smoother and faster issuance process.

Trends To Watch In 2018

We see a couple of interesting trends in the market that are likely to shape its performance in 2018 and onward. These include:

More stringent application of the profit-and-loss-sharing principle

Several Sharia scholars are pushing the market toward more stringent application of the profit-and-loss-sharing principle in sukuk legal documentation. While we do not opine on Sharia compliance, we are of the view that such a development could deprive the market of an important class of investors (fixed-income investors) and ultimately lead to higher pricing. For a corporate entity or a sovereign, this trend is likely to reduce the attractiveness of sukuk due to legal complexity and higher costs. From a rating perspective, we can rate sukuk issued by financial institutions with loss-absorption features. However, it is unlikely that such sukuk would receive the same rating as their sponsors, since the risks are very likely to be higher.

A broadening of the investor base to include retail investors or waqf money

Promoters of this idea believe that retail investment or waqf money could lift sukuk issuance and reduce pricing by boosting demand. Although it is not our role to advise waqf investors about asset allocation, we observe they are generally not after profit maximization but rather the fulfillment of certain social objectives. That's why we saw a connection between waqf and the financing of sustainable development goals, for example. In addition, in light of the significant oversubscription of most sukuk issued, we think softness in the market is due to a lack of supply rather than demand. The necessity for Islamic financial institutions to hold a certain amount of high-quality liquid assets as part of Basel III compliance adds to the supply-demand gap.

Regarding retail sukuk, we believe that development of this part of the market necessitates a specific regulatory framework to protect investors and ensure proper access to information about risks. Retail sukuk issuance has been successful in some countries where, for example, authorities provided a tax incentive to drain a portion of the savings toward this market. In the GCC, there is currently no income tax, so no opportunity for tax relief; local capital markets remain narrow; and the significant amount of unremunerated deposits on banks' balance sheets suggests that remuneration is not the primary motive for some retail depositors. As such, we think retail sukuk will continue to make a limited contribution to sukuk issuance.

Related Research

- Islamic Finance In 2018: Slow Growth Is The New Normal, June 20, 2017
- Is Sukuk Issuance Suffering From The Liquidity Drop In Gulf Countries? Feb. 6, 2017
- Global Sukuk Market Outlook: The Surge In Sukuk Issuance Isn't The New Normal, June 19, 2017
- Islamic Finance Could Aid Modestly In Achieving Sustainable Development Goals, April 18, 2016
- AAOIFI Proposes Recommendations For Central Sharia Boards: A Step In The Right Direction, Feb. 13, 2017

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Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@spglobal.com