Bright Potential Of Sukuk Market Growth

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Sukuk growth potential is bright, but the Government must continue to lead

Since the first sukuk issuance in 2002 by Indosat, and the 2009 issuance by the Indonesian government, the sukuk market has traveled far. The outstanding amount of government-issued sukuk by the end of September 2014 (9M2014) rose to more than IDR205 trillion, and has grown by nearly 40% over the last three years (IDR77 trillion in 2011). However, the sukuk market is only about 12% of the overall bond market in Indonesia, which reached more than IDR1,700 trillion as of 9M2014. Corporate sukuk are even lower, at only IDR7.0 trillion, of which PEFINDO rated most of the sukuk at more than IDR6.0 trillion outstanding at end of September 2014.

In comparing the composition of the bond and sukuk markets between Malaysia and Indonesia, it is apparent the developments in Malaysia are far ahead. Malaysia pioneered Islamic financing more than 30 years ago, compared to Indonesia in only 2002. Malaysia's overall bond market, at MYR1.2 billion, or about USD370 million, is more than twice the size of Indonesia's. However, the most striking difference is the portion of sukuk in comparison to conventional bonds: as of 9M2014, it was 32% among government-issued sukuk and around 68% among corporates. Although Indonesia does not need to copy that particular balance between sukuk and conventional bonds, it certainly portrays the potential growth of the corporate sukuk market in a more mature setting.

Table 1. Indonesia & Malaysia Comparison

	9M2014		FY2013		FY2012		FY2011	
Sukuk & Conventional Bond Outstanding	**Indonesia (IDR Tn)**	**Malaysia (MYR Bn)**	**Indonesia (IDR Tn)**	**Malaysia (MYR Bn)**	**Indonesia (IDR Tn)**	**Malaysia (MYR Bn)**	**Indonesia (IDR Tn)**	**Malaysia (MYR Bn)**
Government Sukuk	205.58	245.85	169.29	223.20	124.44	211.50	77.33	143.80
Government Conventional	1,712.34	523.17	1,491.76	374.30	1,236.66	387.22	1,110.32	354.93
% of Government Sukuk from total Government Issuance	**10.7%**	**32.0%**	**10.2%**	**37.4%**	**9.1%**	**35.3%**	**6.5%**	**28.8%**
Corporate Sukuk	6.96	316.42	7.10	288.93	6.58	264.09	5.88	206.49
Corporate Conventional	213.49	136.22	213.48	144.46	182.86	144.99	142.59	135.98
% of Corporate Sukuk from total Corporate Issuance	**3.2%**	**69.9%**	**3.2%**	**66.7%**	**3.5%**	**64.6%**	**4.0%**	**60.3%**

Source: DJPU report, BEI Statistics, Malaysia Bond Info Hub website, processed by Pefindo
Note: Between 2011 - Sep 2014, MYR/IDR ranges from 2,850 to 3,713 per IDR.

In fact, the high portion of government sukuk in Indonesia is normal as the sukuk market in Indonesia is at a relatively young age. Even in Malaysia, the global leader in sukuk issuance, those issuances are dominated by its government. Malaysia issued USD82.1 billion of sukuk in 2013, and the majority share (around USD50 billion) was issued by Bank Negara Malaysia, the country's central bank. Similar conditions are seen in the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Qatar, Saudi Arabia, Oman, and the United Arab Emirates) as the next major players in sukuk issuance. Those six countries had combined USD26.5 billion of issuances in 2013, and the majority, at more than 75%, was dominated by sovereign or quasi-sovereign issuances.

While there is more participation from the corporate and foreign investment, which is healthy, the biggest issuances still come from either the governments directly, or state-owned enterprises. For instance, Saudi Electric, a state-owned company with a power monopoly, has issued sukuk certificates worth USD2.5 billion in 2014, following issuances of USD2 billion in 2013 and USD1.75 billion in 2012. In 2014, the UAE saw a first sovereign sukuk of USD750 million issued by the Emirates of Sharjah; USD500 million by Al Hilal Bank, a wholly government-owned Islamic bank of Abu Dhabi; USD700 million by the Investment Corporation of Dubai, a sovereign wealth fund; and USD750 million by the government of Dubai.

There were other first-time issuances by countries during 2014, including non-Muslim nations. South Africa, Hong Kong, Luxembourg, and the United Kingdom also took part, along with Senegal and Pakistan. Although those countries are not dominated by Muslim populations, they are either trying to establish themselves as Islamic finance centers, or simply trying to take advantage of the wealth of Middle East and Asian funds. These first-time issuers enjoyed oversubscription, indicating a healthy appetite for growth. South Africa's sukuk issuance was oversubscribed by four times, Hong Kong's issuance at nearly five times, and the UK's sukuk debut attracted oversubscription of 10 times.

This phenomena is an indication that the potential demand for sukuk is bright, and will likely grow as other countries are preparing for their first move into the market. African nations, such as Egypt, Tunisia, and Morocco, with large Muslim populations, are setting the regulatory framework to accommodate sukuk issuance. However, the Government must continue to lead the way for the sukuk market to further develop. Indonesia, which already has a track record of global sukuk issuance, is ahead of the group in terms of sukuk market development. The market provides diversification to issuers from a wider range of investors, as well as the opportunity to attract wealthy investment from Middle East countries.

Table 2. Indonesia vs. First Time Issuers

Country	LT Rating	Original Currency	Sukuk Issuance Sep 2014 YTD (USD Bn)
Indonesia	BB+/Stable	USD	1.50
South Africa	BBB-/Stable	USD	0.50
Senegal	B+/Stable	CFA	0.20
Pakistan	B-/Stable	PKR	0.50
United Kingdom	AAA/Stable	GBP	0.34
Luxembourg	AAA/Stable	EUR	0.25
Hong Kong	AAA/Stable	USD	1.00
Egypt	B-/Stable	EGP	-
Morocco	BBB-/Stable	MAD	-
Tunisia	Ba3/Negative	TND	-

Source: S&P reports, others, processed by Pefindo.
Exchange rate USD/IDR = 12,212   Exchange rate USD/CFA = 480

Challenges in sukuk development

Considering the small size of the sukuk market in Indonesia, liquidity is still an issue. The secondary market for government sukuk is relatively small, while for corporate sukuk it is practically nonexistent. However, this is quite normal for a young market. As the size continues to grow, so will the liquidity as the appetite and knowledge of market participants develop. Indeed, the process could also be hastened by well-defined regulations. In Indonesia, one significant issue is on the legal process upon default. The weaknesses and inconsistencies found in our legal system have caused many parties to hesitate in issuing sukuk. There are legitimate concerns of whether the underlying assets of the sukuk could be executed appropriately in due time. This is a significant issue that must be dealt with, although given the variety of sukuk types available, it is very difficult to provide a complete solution for all sukuk.

Another fundamental issue is the lack of strategic coordination between key government agencies. Following the example of Malaysia and a number of other countries, providing incentives to potential issuers is very important. This usually involves an attractive tax incentive. Malaysia plans to extend tax breaks on certain sukuk structures that are bought by Middle East investors in an effort to attract more funds from the region. If a similar strategy is employed, Indonesia could boost its sukuk market growth, as well as supporting the growth of infrastructure developments, which would have many trickle-down benefits for the economy.

PEFINDO's view on the corporate sukuk risk profile

When assigning a rating to a sukuk instrument, PEFINDO bases the analysis on the issuer's capability in servicing the instrument. PEFINDO also assesses the transaction structure to fully understand if it is in accordance with sukuk principles. Although the sukuk may have a more advantageous structure which is covered by the collateral, PEFINDO believes that the issue of execution as mentioned above hinders the sukuk to fully receive the benefits from such a structure in comparison to a conventional bond.