

# Innovation in Islamic Liquidity Management 2017

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## Executive Summary

Although the Islamic finance industry is still small relative to the global financial industry, it is on pace to grow from total assets of \$2 trillion at the end of 2015 to an estimated \$3.5 trillion by 2021. This 75% growth in assets in six years will be all the more significant in a slow global growth environment, while facing challenges associated with Basel III implementation characteristic of the post-crisis environment. These regulations impact many aspects of banking, which accounts for three-quarters of Islamic finance assets, but they particularly complicate Islamic liquidity management.

The dearth of Islamic liquidity management instruments has been a challenge in Islamic banking throughout its 40-year growth and maturity. Relatively few instruments have been able to meet both the industry's needs and its stakeholders' full expectations. As a result, Islamic banks in the GCC today hold 8.8% of their assets in cash and equivalents and 9.8% of their assets in placements at other financial institutions. Islamic banks in Bahrain hold over 12% of their assets in the form of cash while banks in Kuwait hold nearly 20% of their assets as placements with other banks.

Currently, Islamic banks place liquid funds in short-term instruments such as commodity murabaha that Shariah rules have deemed non-tradable on secondary markets because of bans on trading receivables. Moreover, stakeholders typically view these inflexible instruments as artificial replications of inter-

est-based transactions. Shariah scholars have been important in influencing perceptions among industry stakeholders. They have allowed commodity murabaha to be used as a temporary solution in limited contexts where no other instruments could be developed. However, the OIC Fiqh Academy has called organized tawarruq, the pre-arrangement of the commodity trades, a 'deception' in a fatwa that has publicized the unease in the industry over these instruments. Replacement instruments are judged against three criteria: whether they are as cost-effective as commodity murabaha, whether they offer the same or enhanced flexibility and liquidity, and whether they offer sufficient scale to meet current and anticipated future needs.

Islamic personal financing also faces a similar perception problem. These liquidity management products receive even more acute

criticism when they are used to structure unsecured personal financing (such as credit cards). Yet the need for financing products that are flexible enough to meet consumers' demands continues to rise. Today, in most markets in the GCC, personal financing represents a quarter or more of the total assets in the banking system. change to the below updated

New strategies to meet the liquidity management and personal financing needs of Islamic banks and Islamic windows at conventional banks are being developed. These products—including National Bonds' Sukuk Trading Platform—address both the operational needs of Islamic banks and preferences of their customers and external stakeholders. In addition, changes to the commodity murabaha structure including in Malaysia and Indonesia can address some of the Shariah objections.

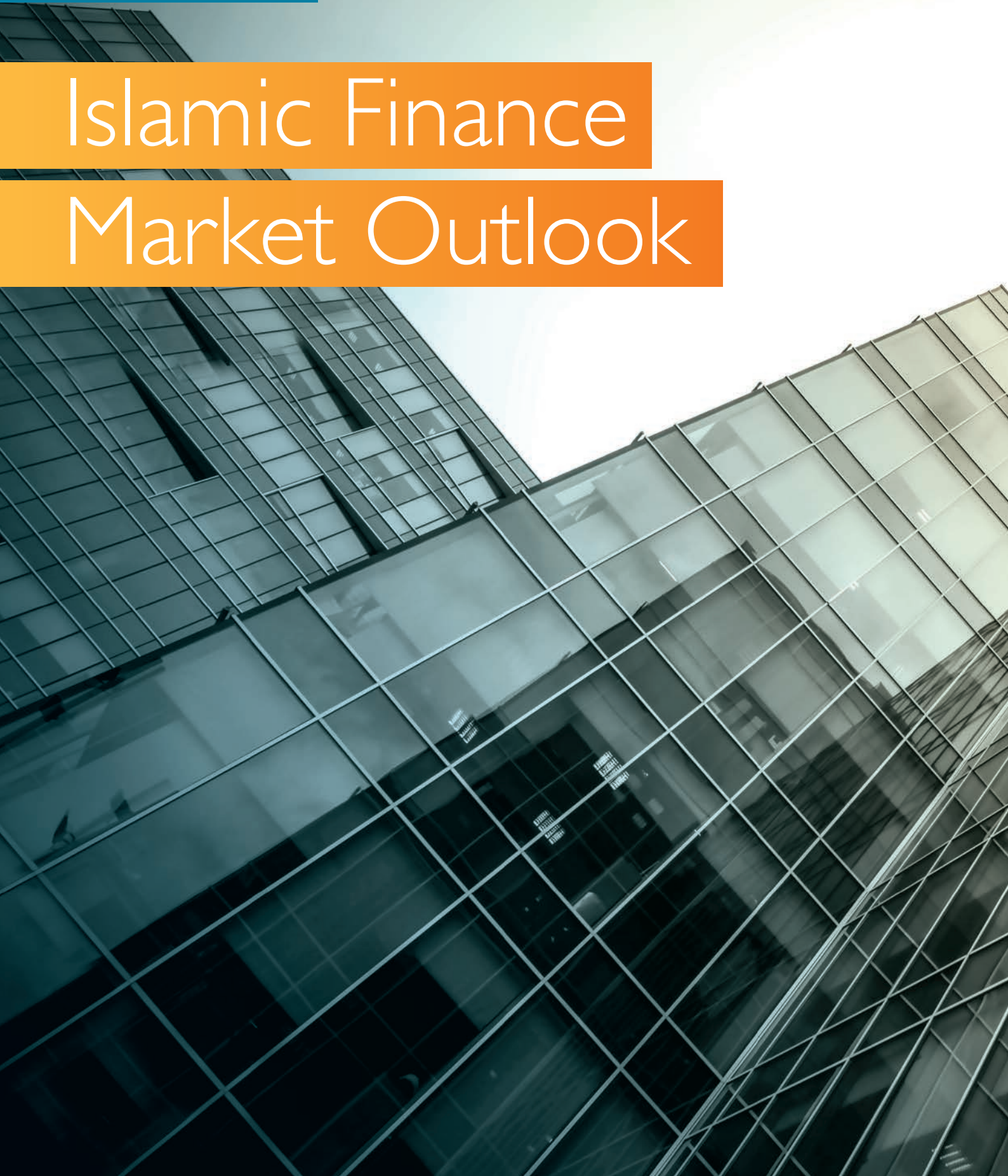
When focusing on liquidity management, in particular, there is a critical need for products that are efficient and flexible to act as a destination of surplus funds and to facilitate the provision of liquidity to banks facing temporary deficits. This need for two-way-capable products is important because the market needs are different across countries and across time as a result of different market structure, shifts in regulatory and monetary policy and developments in key commodity markets like oil.

The Sukuk Trading Platform uses assets financed by National Bonds that contribute to the local economy, like hospitals and educational facilities, to structure Shariah-compliant consumer financing. Its structure segregates the component transactions, which occur on a bilateral basis by the different parties, at different times, with no conditionality. It also provides this service with lower fees than commodity murabaha. This initiative will help make Islamic finance more competitive with similar conventional transactions, a critical step in widening the market for Islamic banks both in established markets like those in the GCC and less developed markets like the UK, Indonesia and across North Africa.

The platform provides a compelling alternative to products in which the premeditated coordination of transactions has stripped away much of the risk but also the Shariah authenticity of many Islamic financing products. As it continues to develop and becomes more widely used, the Sukuk Trading Platform will help return the focus of Islamic finance to underpinning the non-financial, real economy. In liquidity management, it has the potential to be both flexible and authentic, offering an investment destination for surplus funds or a tool with which financial institutions and central banks can look to as a model for providing liquidity to banks in need of it. By fulfilling these needs and setting a positive example for Islamic finance, it also supports Dubai's Islamic economy initiative.

CHAPTER I

# Islamic Finance Market Outlook





# Global Islamic Finance Market

## Introduction to the Islamic Finance Market

The Islamic finance industry emerged in the mid-1970s, when new banks started offering Shariah-compliant products in response to growing societal demand. Although its principles have existed since the inception of Islam, contemporary Islamic finance is still a young market; its total assets of US\$2 trillion in 2015 are miniscule compared to the global finance market. However, it is evolving rapidly, and it potentially serves both a growing 1.7 billion Muslim population worldwide as well as increasingly interested non-Muslim investors.

The market is based on the prohibition of interest-based transactions, which violate the Shariah, along with other excluded or *haram* transactions such as conventional insurance, gambling, and the sale of weapons, alcohol, pork, and pornography. The most common transactions include murabaha (sale contract), ijarah (lease-based) and mudarabah (partnership), while sukuk represents the most common type of Islamic capital markets tool based on these transactions.

As the Islamic finance market matures, many Muslim clients are attracted as much to its diverse offerings of new products and services as they are to strict Shariah compliance. This can be noted in countries with devout Muslims such as Saudi Arabia, where Islamic banking has a 57% share of total banking assets, while in Indonesia, with the world's largest Muslim population, Islamic banking has only a 5%

market share. Moreover, many sceptics point out that the distinction between Islamic products (such as murabaha or sukuk) and their conventional peers are minimal and result in similar outcomes.

Despite these challenges, governments have not stopped introducing or promoting Islamic finance products. Regulatory authorities from Muslim-majority countries like Pakistan and the UAE eagerly encourage different Islamic finance sectors while ensuring proper oversight of the market. Western nations like Luxembourg and the UK, and leading corporations such as Goldman Sachs, have raised funds through sukuk in recent years. This has led to the increased appeal of sukuk and increased awareness about Islamic finance worldwide.

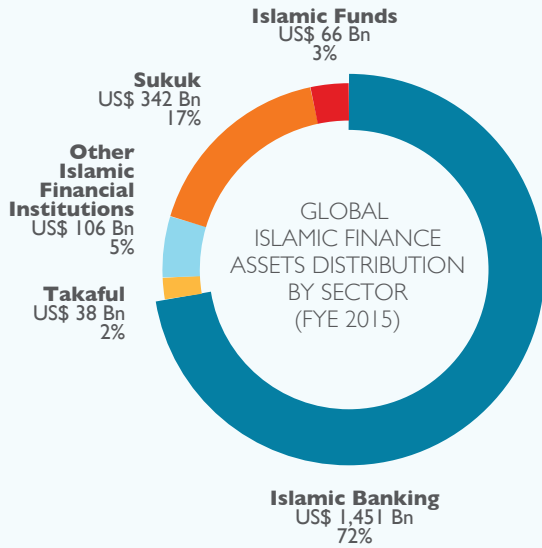
Moreover, according to the ICD Thomson Reuters Islamic Finance Development Indicator and Report, many nations are showing interest in the market, with an increasing number of news, conferences or seminars related to the Islamic finance sector being held in countries that do not have an Islamic finance presence yet, such as Bulgaria, Macedonia and Nepal. Islamic finance education, which is a key element for the market's growth, has a presence in 64 nations through 622 educational institutions in 2015. In addition, Islamic finance scholars published 2,224 papers research papers between 2013 and 2015, through different affiliations in 71 countries around the world.<sup>1</sup>

1. The ICD-Thomson Reuters Islamic Finance Development Indicator is a composite weighted index that measures the overall development of the Islamic finance industry by providing an aggregate assessment of the performance of all its parts, in line with the objectives of Islamic principles. To learn more visit <https://islamic-finance.zawya.com/islamic-finance-development-indicator/>

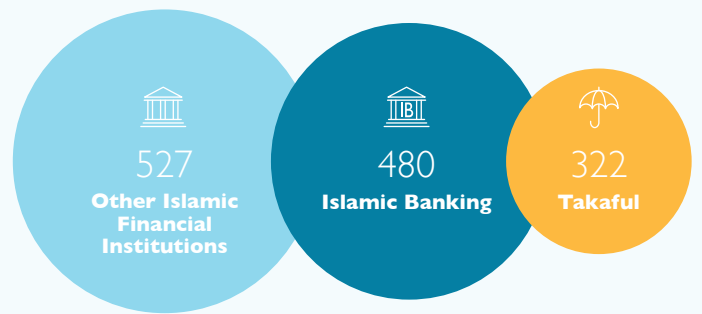


# Current Size of the Market Globally and Potential for Future Growth

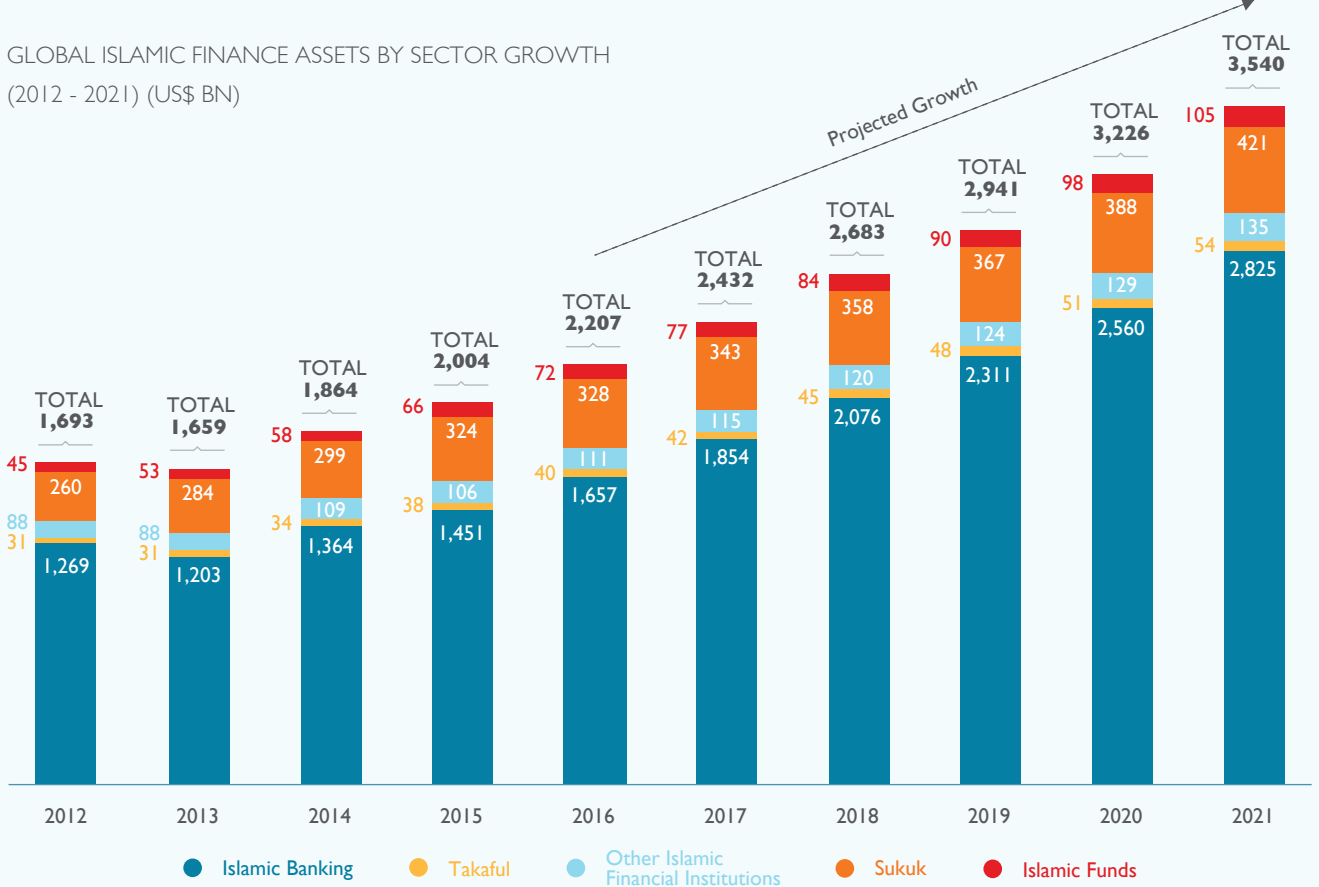
Total Islamic Finance Assets in 2015:  
**US\$2Tn**



NUMBER OF ISLAMIC FINANCE INSTITUTIONS (FYE 2015)



GLOBAL ISLAMIC FINANCE ASSETS BY SECTOR GROWTH (2012 - 2021) (US\$ BN)



Source: ICD- Thomson Reuter Islamic Finance Development Indicator 2016

*A US\$2 trillion milestone in 2015*

Global Islamic finance assets totalled US\$2.004 trillion at the end of 2015, held in 60 countries. Islamic banking is the biggest contributor, with US\$1.45 trillion or 73% of total Islamic finance assets at full-fledged Islamic financial institutions or windows at conventional institutions. Most Islamic financial assets are held at fully fledged Islamic financial institutions. However, this share has declined since 2012 as a result of the entrance of new conventional financial institutions offering Islamic products, such as Omani Islamic banking windows, since 2013 or Pakistani takaful windows, since 2015.

In 2015, 1,329 financial institutions offered Islamic financial products, including Islamic banks, takaful operators and other Islamic financial institutions, encompassing window or Islamic department operations. Most of these institutions are based in the GCC and Southeast Asia, with a smaller number distributed between other Middle East countries such as Iran, Africa, Europe and other regions.

*Sustained growth of the market globally*

The aggregate value of Islamic finance assets had an annualized growth rate of 18% between 2012 and 2015. Islamic capital markets assets grew the fastest during this period: 47% annual growth for Islamic funds assets under management, and 31% annual growth in the value of outstanding sukuk. Yet Islamic banking remains the biggest overall growth driver of the Islamic finance market's assets given its large share of total Islamic finance assets. Total Islamic finance assets dropped in 2013 because of the weakening of local currencies in some Islamic finance strongholds such as Iran, second only to Saudi Arabia in Islamic finance assets.

Total Islamic finance assets are projected grow at 10% per year in the coming six years, to reach US\$3.5 trillion in 2021. Because of its size compared to other Islamic finance sectors, Islamic banking will remain the biggest contributor, with average annual growth of 11% to 12% per year from 2015 to 2021. As a result, is expected that Islamic banking's share of Islamic finance assets will grow from 73% in 2015 to 80% by 2021. This projection is supported by the strength of the Islamic banking sector in several nations, especially in the top ten countries in terms of Islamic finance assets, highlighted in the next section. Global growth is also supported by the continual introduction and development of Islamic finance in new countries.

### Islamic Finance Concentration and Areas of Geographical Focus

#### Top ten countries: A close finish for Saudi Arabia and Iran

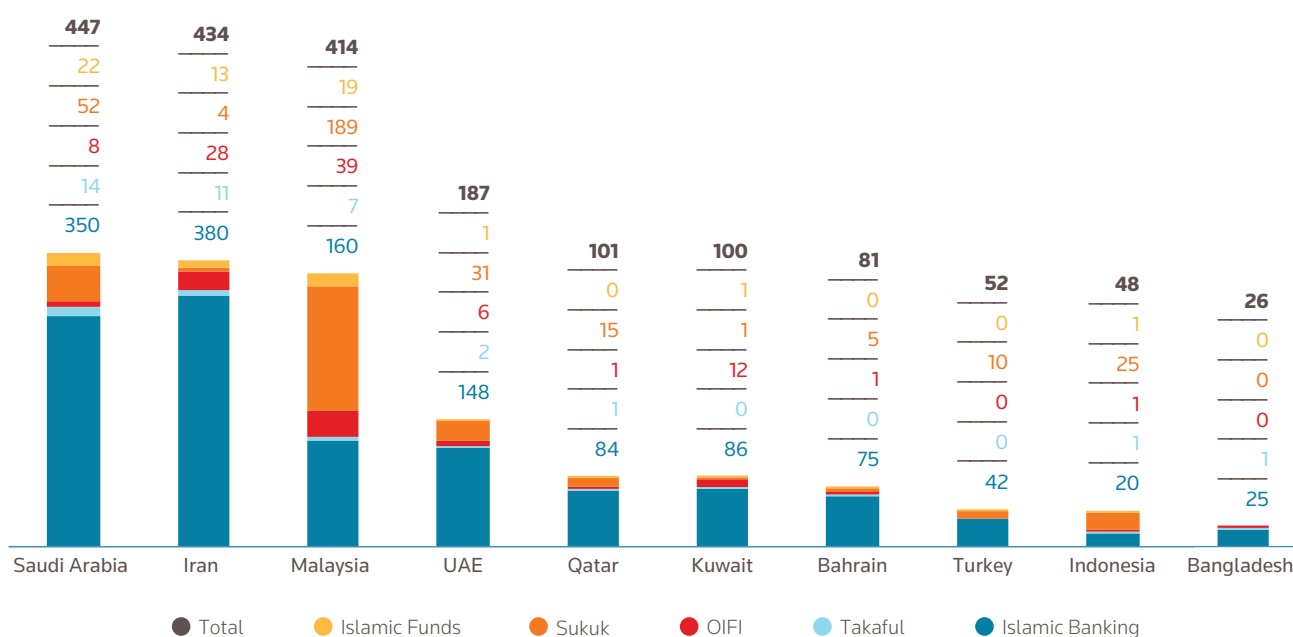
Saudi Arabia has the world’s largest body of Islamic finance assets, worth US\$447 billion, supported by the nation’s strong Islamic banking sector. As a result of a decline in oil prices, the kingdom introduced the Vision 2030 plan, aiming to end its dependence on oil by raising non-oil revenues by US\$1 trillion by 2030. The introduction of this plan could mean increased financing by its banking sector including Islamic banks towards non-oil sectors. The kingdom also opened its stock exchange to foreign investors in 2015, which will draw more capital to the region, increasing Islamic funds allocations for equity-based investments in the country.

Iranian Islamic finance institutions hold only US\$13 billion less than those in Saudi Arabia. In January 2016, UN sanctions on Iran were lifted, which will allow its Islamic finance and oil industry to re-enter the global economy. It is therefore expected that Iran’s banking system will enter the global economy with caution as it needs to strengthen the weaker aspects of its fi-

ancial system, such as liquidity management and Basel III requirements. However, this is expected to occur only after a few years, as European banks remain hesitant to deal with Iranian banks while U.S. banks are still restricted by the domestic sanctions from doing business in Iran.

In Malaysia, sukuk is a much more prominent constituent of Islamic finance, with 46% of total assets—a sign of Malaysia’s world prominence in sukuk in 2015. The ICD-Thomson Reuters Islamic Finance Development Indicator has judged its sukuk market as the most developed in the world for four consecutive years. In addition, In July 2013, Malaysian regulators introduced the Islamic Financial Services Act (IFSA 2013), replacing the old Islamic Banking Act 1983 and Takaful Act 1984. It is expected that this landmark act will improve the observance of Shariah and operational compliance guidelines for Malaysia’s Islamic financial institutions. It also introduced the Shariah-compliant Employee Provident Fund (EPF), Malaysia’s retirement saving fund, and it is expected to allocate US\$7.43 billion to this fund in 2018.

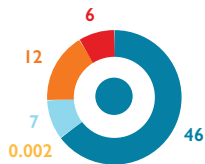
#### TOP 10 COUNTRIES IN ISLAMIC FINANCE ASSETS (US\$ BN, FYE 2015)



Source: ICD-Thomson Reuter Islamic Finance Development Indicator 2016

# Islamic Finance Assets by Region

## A wide range in the sector landscape (US\$ Bn, 2015)



### EUROPE & AMERICAS

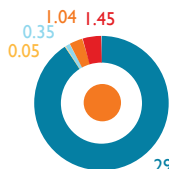
**US\$ 72 Bn**  
Total Islamic Finance Assets in 2015

**Turkey (US\$ 52 Bn)**  
Top Country in Terms of Islamic Finance Assets in 2015

**7%**  
Average Growth of Total Islamic Finance Assets (2012-2015)

**Italy**  
Fastest Growing Country in Islamic Finance Assets (2012-2015)

**91**  
Total Islamic Finance Institutions



### AFRICA

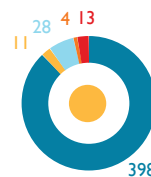
**US\$ 32 Bn**  
Total Islamic Finance Assets in 2015

**Egypt (US\$ 14 Bn)**  
Top Country in Terms of Islamic Finance Assets in 2015

**7%**  
Average Growth of Total Islamic Finance Assets (2012-2015)

**Gambia**  
Fastest Growing Country in Islamic Finance Assets (2012-2015)

**187**  
Total Islamic Finance Institutions



### MIDDLE EAST (EXCLUDING GCC)

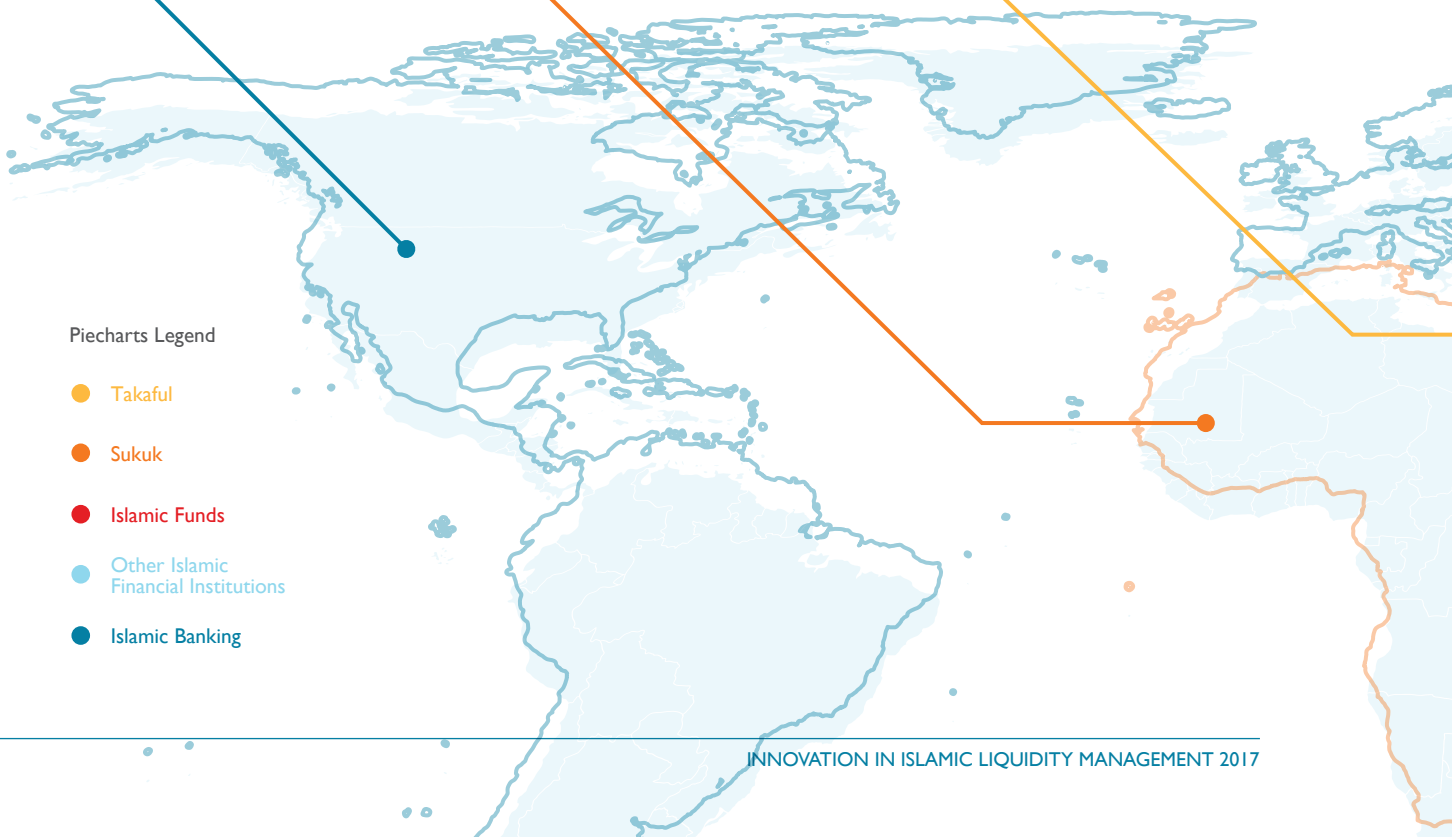
**US\$ 453 Bn**  
Total Islamic Finance Assets in 2015

**Iran (US\$ 434 Bn)**  
Top Country in Terms of Islamic Finance Assets in 2015

**0.4%**  
Average Growth of Total Islamic Finance Assets (2012-2015)

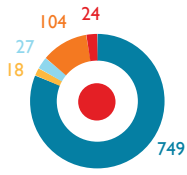
**Palestine**  
Fastest Growing Country in Islamic Finance Assets (2012-2015)

**187**  
Total Islamic Finance Institutions



Piecharts Legend

- Takaful
- Sukuk
- Islamic Funds
- Other Islamic Financial Institutions
- Islamic Banking



**GCC**

**US\$ 922 Bn**

Total Islamic Finance Assets in 2015

**Saudi Arabia (US\$ 447 Bn)**

Top Country in Terms of Islamic Finance Assets in 2015

**14%**

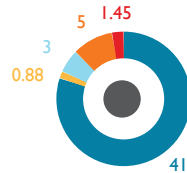
Average Growth of Total Islamic Finance Assets (2012-2015)

**Oman**

Fastest Growing Country in Islamic Finance Assets (2012-2015)

**425**

Total Islamic Finance Institutions



**OTHER ASIA**

**US\$ 51 Bn**

Total Islamic Finance Assets in 2015

**Bangladesh (US\$ 26 Bn)**

Top Country in Terms of Islamic Finance Assets in 2015

**18%**

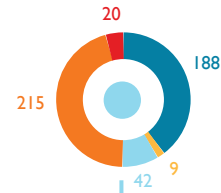
Average Growth of Total Islamic Finance Assets (2012-2015)

**Hong Kong**

Fastest Growing Country in Islamic Finance Assets (2012-2015)

**198**

Total Islamic Finance Institutions



**SOUTHEAST ASIA**

**US\$ 473 Bn**

Total Islamic Finance Assets in 2015

**Malaysia (US\$ 414 Bn)**

Top Country in Terms of Islamic Finance Assets in 2015

**3%**

Average Growth of Total Islamic Finance Assets (2012-2015)

**Indonesia**

Fastest Growing Country in Islamic Finance Assets (2012-2015)

**241**

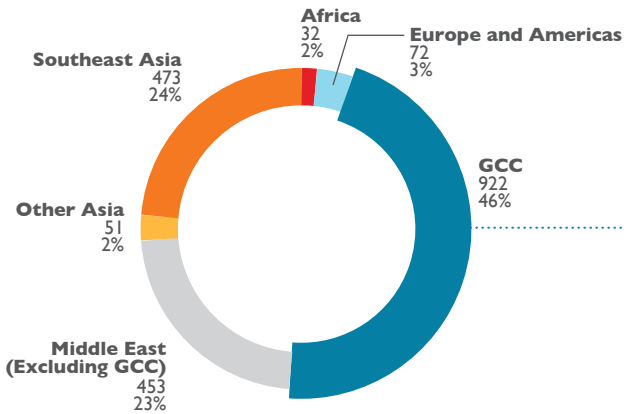
Total Islamic Finance Institutions



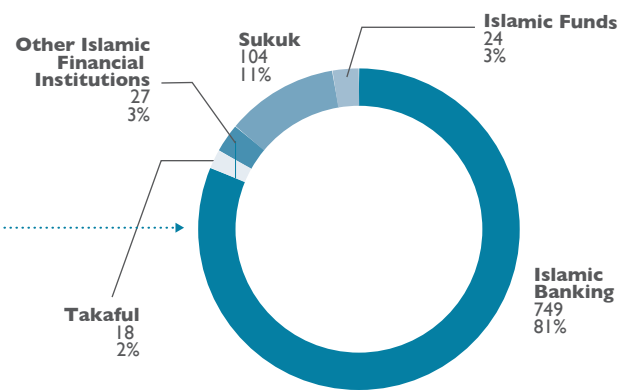
Source: ICD-Thomson Reuter Islamic Finance Development Indicator 2016

# GCC Islamic Finance Landscape in 2015

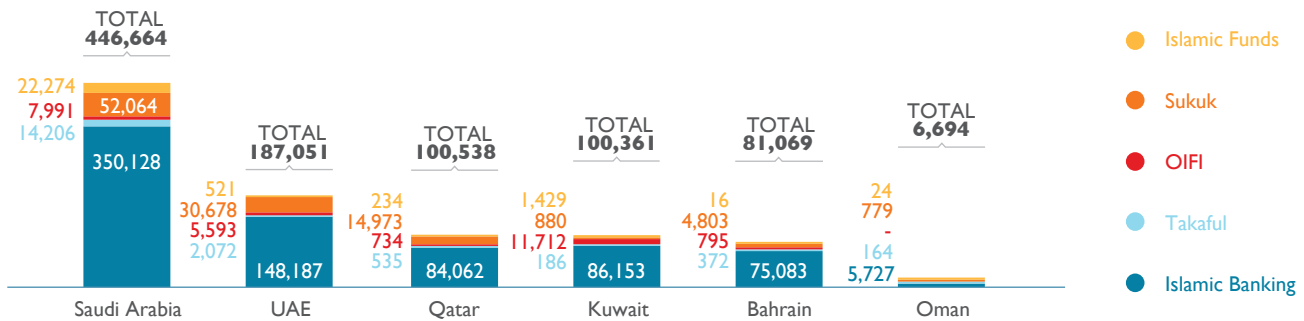
GLOBAL ISLAMIC FINANCE ASSETS DISTRIBUTION BY REGION (US\$ BN)



GCC ISLAMIC FINANCE ASSETS DISTRIBUTION BY SECTOR (US\$ BN)



GCC ISLAMIC FINANCE ASSETS DISTRIBUTION BY COUNTRY (US\$ MN, FYE 2015)



## NUMBER OF ISLAMIC FINANCIAL INSTITUTIONS PER COUNTRY

Country	Islamic Bank	Other Islamic Financial Institutions	Takaful	Total
Saudi Arabia	16	71	40	127
Kuwait	8	76	15	99
United Arab Emirates	24	46	17	87
Bahrain	36	19	9	64
Qatar	8	10	19	37
Oman	9	-	2	11

Source: ICD-Thomson Reuter Islamic Finance Development Indicator 2016

## GCC Region: Driven by strong Islamic banking growth

The other GCC members follow Saudi Arabia, Iran and Malaysia in terms of total Islamic finance assets of the top ten nations in 2015, except for Oman, where the market only began operations in 2012.

In addition, the GCC countries have the largest total Islamic finance assets by region in the world, driven mainly by Islamic banking, with 81% of total GCC Islamic finance assets. This is a larger share than global Islamic banking assets, which represent 73% of total global Islamic finance assets.

## A positive outlook for the GCC Islamic finance market: country by country

In 2015, the **UAE** had the second largest total of Islamic finance assets in the GCC, and was fourth worldwide. Its assets grew 15% on average per year from US\$124 billion in 2012 to US\$187 billion, of which 80% were concentrated in Islamic banking. The country is also a leader on the sukuk front, with the third largest value of outstanding sukuk in the world, and fourth in terms of 2015 issuances. The Islamic finance market in the UAE is expected to strengthen. In May 2016, the UAE cabinet approved the creation of a centralized Shariah authority to oversee all sectors of the country's Islamic finance market. Additionally, the emirate of Dubai introduced its World Capital of the Islamic Economy initiative in 2013, which also ensures that its Islamic finance market has well defined infrastructure and supervisory oversight.

Ranked third in the GCC and fifth globally, **Qatar** was the only GCC nation to introduce a ban on Islamic windows, closing this business at conventional banks by the end of 2011. Since then, its Islamic finance assets have grown 12% on average annually to US\$101 billion in 2015. The latest addition to this total for 2016 is the issuance of QR 1.6 billion in (US\$440 million) sukuk, with an additional bid by banks for QR 2.4 billion in August. During the same period, the state issued QR 3 billion in conventional bonds and additional bids for QR 50 million.

Qatar is closely followed by **Kuwait** and **Bahrain**, which have US\$100 billion and US\$81 billion in assets, respectively. Among their recent regulatory milestones, Kuwait's Capital Markets Authority (CMA) issued sukuk rules in a move to prepare for a sovereign sukuk issuance to cover the 2016/17 budget deficit resulting from lower oil prices. In September 2016, Bahrain's central bank proposed new Shariah governance rules requiring Islamic banks to have external Shariah audits of their banking operations with Islamic advisory firms. With these rules, Bahrain has become among the strictest jurisdictions for Shariah governance.

**Oman** is the most recent GCC nation to join the Islamic finance market, in 2012. Since that time, it has licensed three Islamic banks and six Islamic banking windows, two takaful operators and seen corporate and sovereign sukuk issuances. Together, these Islamic finance sector assets and asset classes amounted to US\$7 billion in Oman in 2015. As it is catching up, Oman has had the fastest growth rate in Islamic finance assets of the GCC, with an average of 69% growth per year between 2012 and 2015. Oman's Ministry of Finance is expected to issue US\$2.5 billion in sukuk to plug a budget gap caused by low oil prices, similar to other states in the GCC, which will further increase its outstanding sukuk.

## Islamic Banking

### Top GCC and UAE Islamic Banks

#### *Islamic banks in the GCC are facing liquidity hurdles because of low oil prices*

Currently, there are 101 Islamic banks (including windows) in the GCC: 16 in Saudi Arabia, 8 in Kuwait, 24 in the UAE, 36 in Bahrain, 8 in Qatar and 9 in Oman. The region's first multi-lateral Islamic bank, the Islamic Development Bank headquartered in Saudi Arabia, and first Islamic commercial bank, Dubai Islamic Bank in the UAE, were both established in 1975.

In terms of asset size, Saudi Arabia's Al Rajhi Bank is the region's and world's largest Islamic bank. It is followed by Kuwait Finance House (KFH) and Dubai Islamic Bank (DIB). However, Qatar Islamic Bank (QIB) surpassed KFH and DIB's financing levels in Q2 2016. Bank Nizwa, which is Oman's first full-fledged Islamic bank since 2013, passed the US\$1 billion mark in Q2 2016, and it is the fastest growing Islamic bank in terms of deposits and financing in the GCC.

Due to tightening liquidity conditions in the GCC banking system caused by lower oil prices, some central banks such Saudi Arabia's Monetary Authority (SAMA) have sought to ease conditions, raising its loan-to-deposit ratio from 85% to 90% in February 2016. This rise will make more money available for financing and will prevent corporate rates from rising further. Notably, Al Rajhi Bank and other banks in the GCC increased their LTD ratio as well from 2015 until Q2 2016, which is reflected in higher financing growth compared to deposit growth. However, this measure is traditionally considered a negative one by rating agencies, as higher LTD means a lower liquidity safeguard for the banks themselves to cover any unforeseen funding requirements. Of the top Islamic banks in the GCC, Bank Nizwa has the highest LTD ratio and faced a loss in 2015 and 1H 2016.

#### *Sukuk take a large slice of GCC Islamic bank balance sheets*

Sukuk is the most important constituent of Islamic bank investments, except for Al Rajhi Bank and Bank Nizwa. For Al Rajhi, murabaha with SAMA constitutes 92% of its investments, while for Bank Nizwa, wakalah predominate as investments on its balance sheet. Funds and equities contribute smaller portions on all of these banks' balance sheets.

Of the top GCC Islamic banks from GCC countries other than the UAE, QIB has issued sukuk worth US\$2.8 billion. It issued its latest US\$750 million sukuk, the second tranche of its US\$1.5 billion sukuk program, in October 2015 with 2.33 times oversubscription. A program to double its size to US\$3 billion received approval by its shareholders in February 2016, which could be used for potential acquisitions by the bank. It also raised US\$550 million from Tier 1 perpetual sukuk in July 2015, and it is waiting for the remaining US\$824 million issuance of the Tier 1 program. While Al Baraka Banking Group's Bahrain subsidiary, Al Baraka Islamic Bank, did not issue sukuk, its subsidiaries based in Turkey and Pakistan issued several sukuk including Tier 2 capital-boosting sukuk. In January 2016, Kuwait's largest Islamic lender, KFH, was reported to issue capital-boosting sukuk as well that will either enhance Tier 1 capital or supplementary Tier 2 capital.



## MAJOR MILESTONES IN DEVELOPMENT OF ISLAMIC BANKING

Month - Year	Country	Event
1963	Egypt	First modern Islamic Savings Bank opened in Mit Ghamr
1975	Saudi Arabia	Islamic Development Bank established in Saudi Arabia
1975	UAE	Dubai opens the first Islamic commercial bank, Dubai Islamic Bank
1977	Kuwait	Kuwait Finance House established as Kuwait's first Islamic bank
1979	Pakistan	Pakistan attempts to Islamize the country's financial system
1979	Bahrain	Establishment of Bahrain Islamic Bank as the kingdom's first commercial bank
1982	Qatar	Qatar Islamic Bank established as Qatar's first Islamic bank
1983	Malaysia	Malaysia opens its first official Shariah-compliant bank, Bank Islam
1983	Sudan	Sudan creates a dual conventional/Islamic banking system
1984	Iran	Iran switches to interest-free banking at the national level
1991	Bahrain	The Financial Accounting Organization for Islamic Banks and Financial Institutions (now known as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)) was established
1991	Indonesia	Indonesia introduces its first Islamic bank, Bank Muamalat
2001	Bahrain	Establishment of the General Council for Islamic Banks and Financial Institutions (CIBAFI)
2002	Bahrain	International Islamic Financial Market (IIFM) got established as a standard-setting body for the Islamic financial services market
2003	Malaysia	Establishment of the Islamic Financial Services Board (IFSB) as a standard-setting organization
2004	UK	Islamic Bank of Britain (now known as Al Rayan Bank) established as UK's first Islamic bank
2010	Malaysia	International Islamic Liquidity Management (IILM) established by several authorities to facilitate Islamic liquidity management
2013	Oman	Bank Nizwa started operating as Oman's first full-fledged Islamic bank
Feb. 2014	Bahrain	Bank Al Salam and BMI merge
May 2014	Uganda	Introduction of Islamic banking approved by the Cabinet
Aug. 2014	Tajikistan	Islamic banking law comes into force
Oct. 2014	Saudi Arabia	Pledge by National Commercial Bank to become fully Islamic
Nov. 2014	Morocco	Islamic finance law approved
Feb. 2015	Cameroon	Launch of Islamic window by Afriland First Bank
Feb. 2015	Nigeria	Guidelines established for Islamic finance advisory body by Nigeria's central bank
July 2015	Germany	Opening of Germany's first Islamic bank (KT Bank) in Frankfurt
Aug. 2015	Seychelles	BMI Offshore bank to become fully Shariah compliant
Sep. 2015	Singapore	Winding down of DBS Group's Islamic banking unit
Oct. 2015	Japan and UAE	Launch of Islamic finance operations by Mitsubishi UFJ in UAE
May 2016	Indonesia, Saudi Arabia and Turkey	Islamic Development Bank along with three nations plan to establish an infrastructure-oriented Islamic bank
June 2016	Morocco	Approval for Islamic banks to start operations in 2017

### *Declining growth for UAE Islamic banks' financing books and deposit accounts*

The UAE Islamic banking system has 9 full-fledged Islamic banks and 15 Islamic banking windows. The latest entrant is Bank of Tokyo-Mitsubishi UFJ, which received approval from Dubai Financial Services Authority to operate an Islamic window in July 2015. It aims to provide Islamic commercial financing and other trade finance services.

The largest three Islamic banks by assets include UAE's oldest Islamic bank, Dubai Islamic Bank (DIB), Abu Dhabi Islamic Bank (ADIB), which was established in 1997, and Emirates Islamic Bank (EIB), which opened in 2004 and is owned by one of UAE's largest banks, Emirates NBD. These full-fledged banks hold 60% of UAE's Islamic banking assets.

Overall, the top Islamic banks remain funded largely by deposits, as indicated by their high ratio of deposits to total liabilities. However, it was reported in August 2016 that the value of total UAE bank deposits was declining because of a shortage in systemic liquidity resulting from the decline in oil prices. The top two Islamic banks experienced declining growth in deposits while the third place, EIB, experienced an absolute decline in deposits between Q2 2015 and Q2 2016.

In addition, the drop in oil prices has led some lenders to become more cautious, especially after the emergence of reports of SMEs delaying payments or defaulting on bank loans. This trend has helped cause the slower financing growth at the top three Islamic banks in Q2 2016. The UAE is aiming to intervene by finalizing its bankruptcy law before the end of 2016 to help small companies restructure or wind themselves up. Currently, many executives of

troubled companies flee the country because of existing laws that can send businessmen to jail for unpaid debts.

Murabaha is the most popular financing product offered by the top three UAE Islamic banks, which structures on average 66% of total financing provided by these institutions. Commodity murabaha provided by ADIB and DIB represented 11% and 24%, respectively, of total UAE murabaha financing in 2015. Since 2014, each bank's commodity murabaha balances increased by 39% and 68%, reaching US\$7 and \$8 billion respectively. As for EIB, it has reported that most of its financing and investment income comes from commodity murabaha, which represents 35% of such income in 2015, an 18% increase from 2014. Commodity murabaha has proven to be a popular product offered by UAE Islamic banks, as the product aims to manage liquidity and provide cash advances to customers whenever clients need it.

Among the top banks in Q2 2016, the financing-to-deposit ratio remained at 68% for DIB, declined slightly to 81%, at ADIB but increased at EIB to 113%. EIB's increase is in line with UAE's banking overall LTD ratio increase from 100.9% in 2015 to 103.3% because of the tightening of liquidity experienced by UAE banks. However, the difference in the pace of financing and deposits growth narrowed for all the top banks in Q2 2016 as compared to 2015, indicating a decrease in liquidity pressure on them.

Sukuk investments remain the most dominant investment assets at the top three Islamic banks, where sukuk investments are on average of 75% of such assets. In geographic terms, the sukuk in which these banks invest mostly originated in the UAE.

*Sukuk is widely issued by UAE Islamic banks, especially after the introduction of Basel III rules*

The top three Islamic banks in the UAE have made 14 sukuk issuances worth US\$9.65 billion as of August 2016, all denominated in USD and issued internationally. They account for 45% of the total sukuk issued by Emirati Islamic financial institutions. They are listed between Nasdaq Dubai, London and Irish stock exchanges. Seven of these sukuk are structured as musharakah, three are wakalah, three are mudharabah, and one is ijarah based.

The first of such sukuk was issued by ADIB in 2006, the first tranche of which was US\$800 million out of a US\$5 billion program. Two more tranches of the same program have been released to date. The second tranche was issued in 2010 and matured in 2015, and the third tranche was issued in 2011 and will mature in November 2016.

DIB has issued the largest amount of sukuk of UAE Islamic banks. Three tranches of its US\$2,500 million sukuk program are outstanding totaling US\$1.75 billion. The latest one closed in March 2016 with 2.4 times oversubscription and maturity in 2021. In addition to the bank's issued sukuk, its subsidiary, Tamweel, issued sukuk as well. The latest issuance amounts to US\$300 million and will mature in 2017.

Meanwhile, EIB's sukuk, issued by EIB Sukuk Company, has issued four tranches amounting

to US\$2.1 billion. The latest five-year US\$750 million tranche was issued in May 2016 and was oversubscribed 2.95 times.

In addition to the sukuk programs mentioned above, the adoption of Basel III and IFSB-15 standard, which provides guidelines on regulatory capital (Tier 1 and Tier 2), led to an increase in number and size of sukuk issuances by Islamic banks globally and within the UAE.

The world's first Additional Tier 1 capital sukuk came from ADIB in November 2012, a US\$1 billion issuance based on mudharabah that was oversubscribed 31 times. As a result of this huge demand, ADIB's perpetual sukuk started a trend. DIB issued a similar sukuk in March 2013 with same size, which was oversubscribed 14 times. Another Tier 1 series by DIB was issued in January 2015 through an SPV priced at 6.75%, and received orders amounting to US\$2.5 billion. To date, the Basel III-compliant sukuk by the UAE Islamic banks are only Tier 1-compliant sukuk.

Although the Tier 1 sukuk issued by ADIB and DIB received huge demand, the perpetual feature of these sukuk is considered relatively risky, as it is similar to equity. On the other hand, because they are based on mudharabah, the equity-like features of these sukuk have had a strong appeal for Islamic finance practitioners.

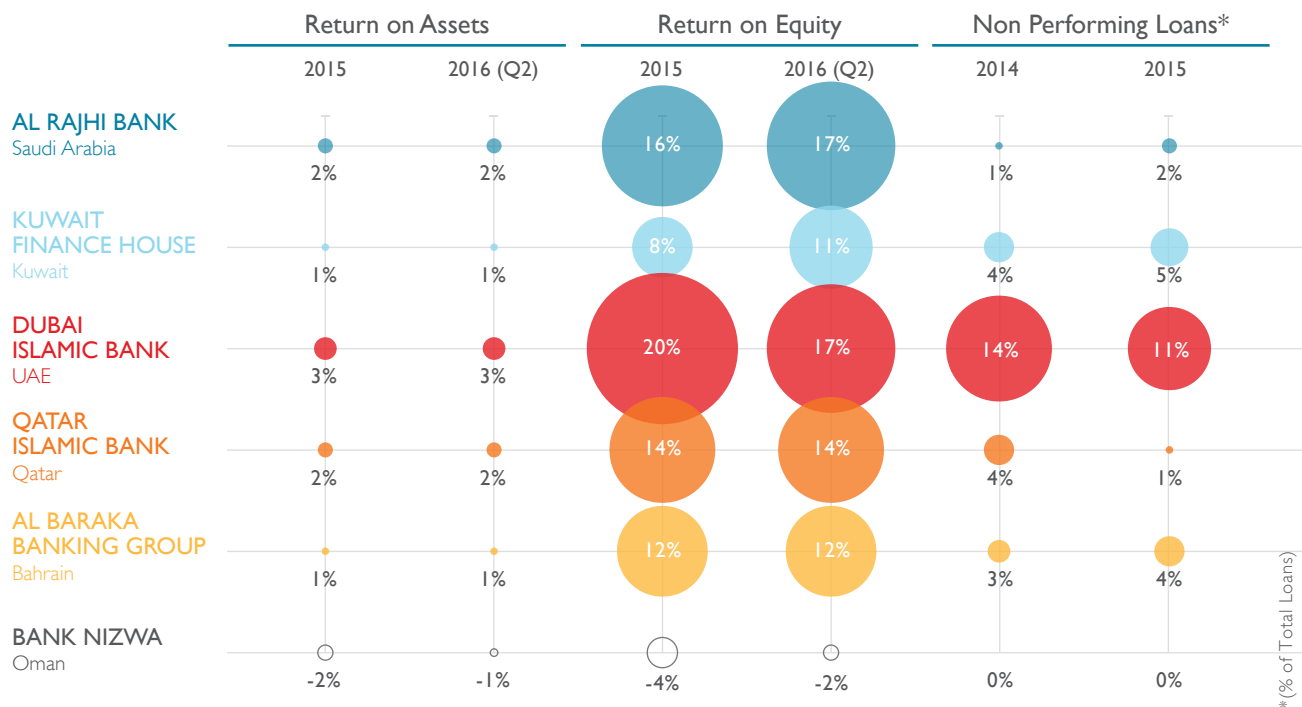
## GCC TOP FULL-FLEDGED ISLAMIC BANKS: FINANCIAL PROFILE

Company	Country	Total Assets (USD Mn)		Local Market Share	Net Financing (USD Mn)		Total Deposits (USD Mn)		Net Income (USD Mn)	
		2015	Q2 2016	2015	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016
Al Rajhi Bank	Saudi Arabia	84,121	88,394	24%	56,028	59,890	69,506	73,262	1,901	547
Kuwait Finance House	Kuwait	54,384	56,489	63%	26,691	28,030	45,375	46,844	485	122
Dubai Islamic Bank	UAE	40,826	46,842	28%	21,385	24,068	31,238	35,589	968	253
Qatar Islamic Bank	Qatar	34,962	36,942	42%	26,638	28,794	28,206	29,705	537	155
Al Baraka Banking Group	Bahrain	24,618	25,044	33%	15,252	15,918	20,164	20,376	163	44
Bank Nizwa	Oman	900	1,096	16%	601	770	378	417	-14	-1

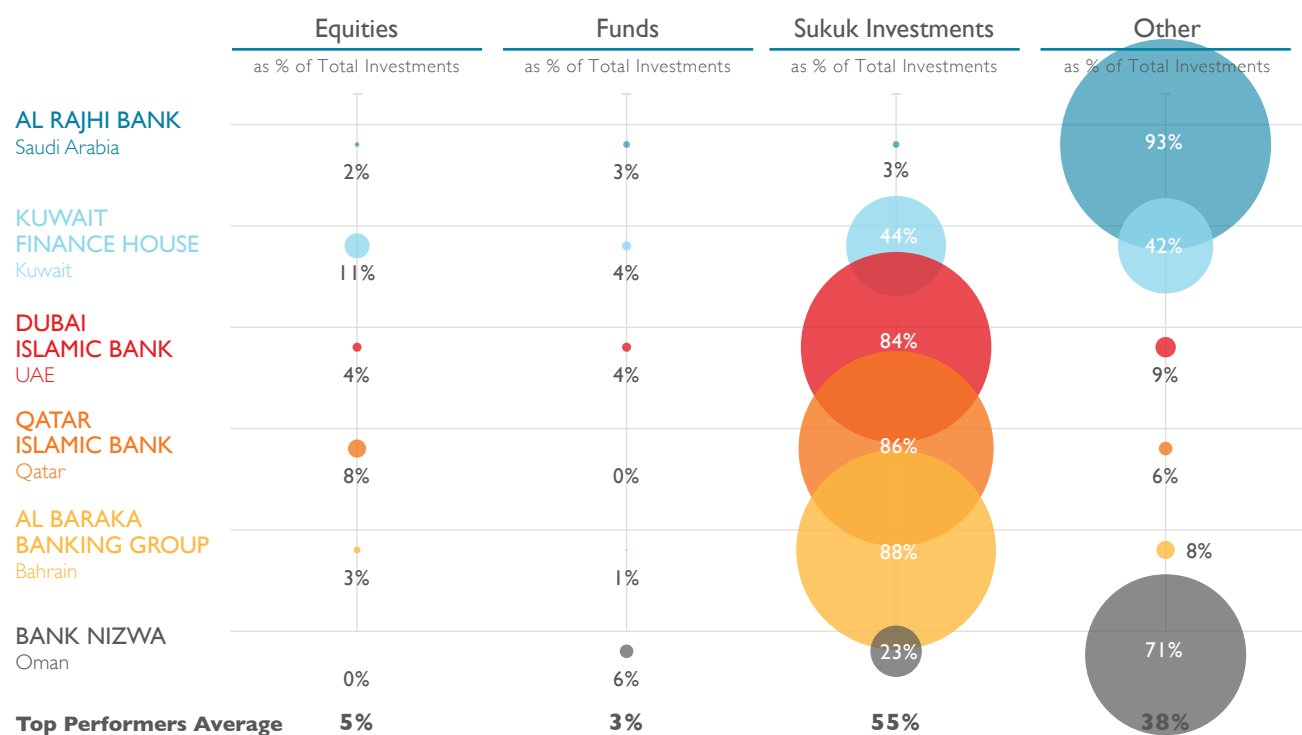
## GCC TOP FULL FLEDGED ISLAMIC BANKS: FINANCING AND DEPOSITS

Company	Country	Financing Growth		Deposit Growth		Financing to Deposit		Deposits as % of Total Liabilities		Financing as % of Total Assets	
		2015	Q2 2016	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016
Al Rajhi Bank	Saudi Arabia	2%	4%	1%	3%	81%	82%	97%	97%	67%	68%
Kuwait Finance House	Kuwait	0%	1%	26%	1%	59%	60%	94%	93%	49%	50%
Dubai Islamic Bank	UAE	25%	2%	19%	5%	68%	68%	89%	88%	52%	51%
Qatar Islamic Bank	Qatar	42%	3%	54%	1%	94%	97%	92%	91%	76%	78%
Al Baraka Banking Group	Bahrain	1%	0%	2%	2%	76%	78%	87%	86%	62%	64%
Bank Nizwa	Oman	109%	12%	60%	4%	159%	185%	66%	54%	67%	70%

## GCC TOP FULL-FLEDGED ISLAMIC BANKS: PERFORMANCE



## GCC TOP FULL-FLEDGED ISLAMIC BANKS: INVESTMENT PORTFOLIOS



## TOP THREE UAE ISLAMIC BANKS: FINANCIAL PROFILES

Company	Total Assets (US\$ Mn)		Assets Local Market Share	Net Financing (US\$ Mn)		Total Deposits (US\$ Mn)		Net Income (US\$ Mn)	
	2015	Q2 2016	2015	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016
Dubai Islamic Bank	40,826	46,842	28%	21,385	24,068	31,238	35,589	968	253
Abu Dhabi Islamic Bank	32,241	33,085	22%	21,795	22,363	26,700	27,581	526	138
Emirates Islamic Bank	14,490	15,571	10%	9,125	10,456	8,997	9,240	174	25

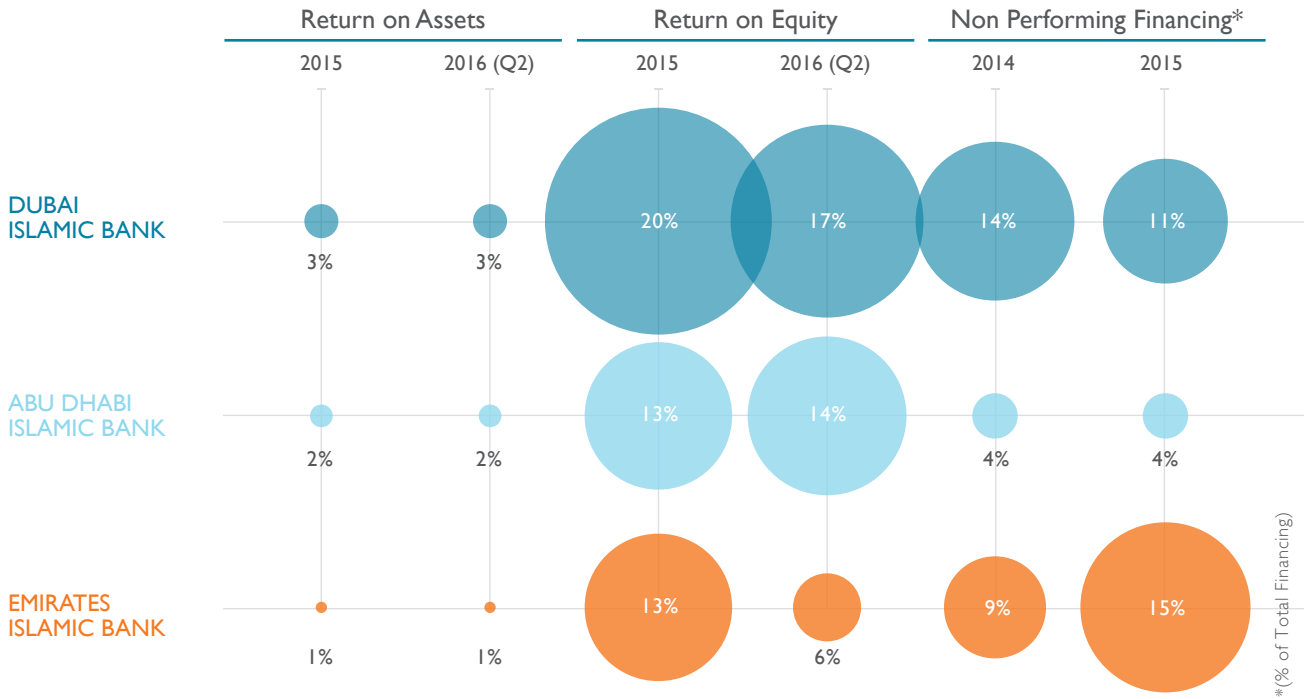
## TOP THREE UAE ISLAMIC BANKS: FINANCING AND DEPOSITS

Company	Financing Growth (YTY)		Deposit Growth (YTY)		Financing to Deposit Ratio		Deposits as % of Total Liabilities		Financing as % of Total Assets	
	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016	2015	Q2 2016
Dubai Islamic Bank	25%	2%	19%	5%	68%	68%	89%	88%	52%	51%
Abu Dhabi Islamic Bank	6%	4%	9%	3%	82%	81%	95%	95%	68%	68%
Emirates Islamic Bank	32%	5%	22%	-7%	101%	113%	69%	65%	63%	67%

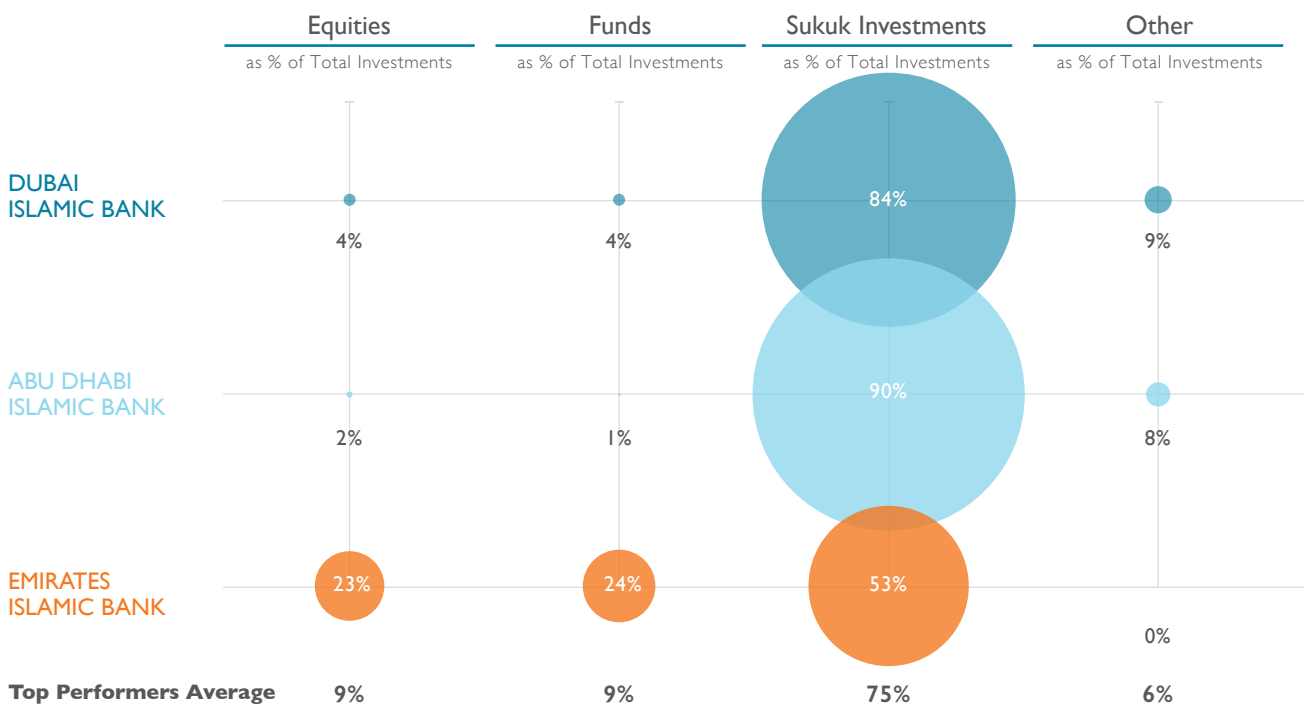
## TOP THREE UAE ISLAMIC BANKS: SUKUK ISSUANCE

	Total Sukuk Issued (US\$ Mn)	Number of Sukuk Issued	Total Sukuk Outstanding (US\$ Mn)	Tier I Sukuk Issued (US\$ Mn)
Dubai Islamic Bank	4,500	4	3,750	2,000
Abu Dhabi Islamic Bank	3,050	6	1,500	1,000
Emirates Islamic Bank	2,100	4	1,750	0
<b>Total</b>	<b>9,650</b>	<b>14</b>	<b>7,000</b>	<b>3,000</b>

### TOP THREE UAE ISLAMIC BANKS: PERFORMANCE



### TOP THREE UAE ISLAMIC BANKS: INVESTMENT PORTFOLIO



## Takaful

### Top GCC and UAE Takaful Operators

#### *Takaful companies in the GCC are facing competitive insurance market and limited investment options*

The GCC Islamic finance landscape includes 102 takaful operators. Of these, 40 companies are based in Saudi Arabia, by far the largest market segment, as all its insurers have become structured on the cooperative insurance model since the passage of the Law on Supervision of Cooperative Insurance Companies in 2002. Health insurance is the biggest contributor to the Saudi market, which produces 53% of total gross contributions written in 2015. Vehicle insurance follows with 29% of GWC in 2015.<sup>2</sup>

Saudi Arabia is followed by Qatar, which has 19 operators, the UAE (17 operators), Kuwait (15 operators), Bahrain (9 operators) and Oman (2 operators). Out the 102 GCC operators, 9 are takaful windows, most of which are composite operators with family and general offerings.

By asset size, the region is dominated by Saudi Arabia's Company for Cooperative

Insurance, which is the second largest takaful company globally. It is three times larger than the second largest operator by country, which is the UAE's Islamic Arab Insurance (Salama). Salama is the fourth largest operator in the GCC, as the second and third largest operators are based in Saudi Arabia as well, and seventh largest globally. Collectively, the largest takaful operators in each GCC country collectively hold 27% of total takaful assets in the GCC.

GCC takaful operators grow based on two basic strategies. First, operators must make underwriting profit and survive competition; second, they need to invest their assets well to make their surplus liquidity produce investment income and cover liabilities from takaful operations. The top GCC takaful operators had mixed performances. The largest companies in Saudi Arabia, Qatar and Oman made profits, while those in the UAE, Kuwait and Bahrain experienced losses in 2015.

<sup>2</sup>. Al Bilad Capital's Saudi Insurance Sector Report 2015.

### TOP FULL TAKAFUL OPERATORS IN EACH GCC COUNTRY: FINANCIAL PROFILES (FYE 2015)

Company	Country	Total Assets (US\$ Mn)	Gross Contributions Written (US\$ Mn)	Net Income (US\$ Mn)	Return on Assets	Return on Equity
The Company for Cooperative Insurance	Saudi Arabia	3,084	2,012	160	6%	27%
Al Khaleej Takaful	Qatar	294	91	12	4%	7%
Takaful International	Bahrain	87	52	-1	-5%	-30%
Al Madina Takaful	Oman	124	81	2	2%	4%
First Takaful	Kuwait	42	Not Reported	-3	-10%	-16%
Islamic Arab Insurance (Salama)	UAE	915	254	-47	-3%	-10%



GCC takaful operators are facing increasing competition from their conventional counterparts, as they need to distinguish their product offerings while maintaining core Islamic values. In addition, oil price volatility is affecting the demand for products like group health insurance plans by corporations, or for commercial insurance. In addition, volatility is affecting the non-technical performance of the operators through their investment portfolios.

For takaful operators, especially family operators, sukuk is one of the most preferred investments because of its long tenors and lower risk profile. Yet, it has been reported that most local insurers in the GCC have real estate and equity assets that are influenced by ongoing economic events<sup>3</sup>. The low sukuk holdings at these operators reflects a limited supply of high-quality sukuk, in contrast with high Malaysian sukuk allocation by Malaysian takaful operators because of a more active sukuk market in Malaysia. In addition, the presence of high liquidity in the Islamic banking system in the GCC, although decreasing with lower oil prices, means that there is a lower supply of sukuk for the region's takaful operators, making them choose less optimal options.

#### *Additional costs for UAE takaful operators*

The introduction of new regulations for the insurance sector in January 2015 made by the UAE Insurance Authority presents a new cost. Like insurance operators, takaful operators in the country are required to adjust and adapt to the new regulations, which include the introduction of improved governance controls, re-alignment of investment portfolios, and others.

The top takaful operators in the UAE varied in their performance in 2015. Salama reported a loss in 2015, resulting from the closure of its BEST RE subsidiary in Malaysia and the highly competitive nature of motor business in the UAE, according to the operator's annual report. It also witnessed a decrease in its investment income by 29%.

Unlike Salama, Aman and Abu Dhabi National Takaful both had positive performances, with the latter having a higher ROA and ROE from a successful strategy, which includes accepting less risky and more profitable contracts. It reported that its technical result improved by 30% as a result of this strategy, although its non-technical investment income decreased by 45% in 2015. Aman's takaful operations loss led to a low net profit. Its 2015 investment income declined from 2014, resulting from a loss of investments measured at fair value though profit or loss (FVTPL), such as equity instruments and debt instruments that do not meet amortized cost criteria.

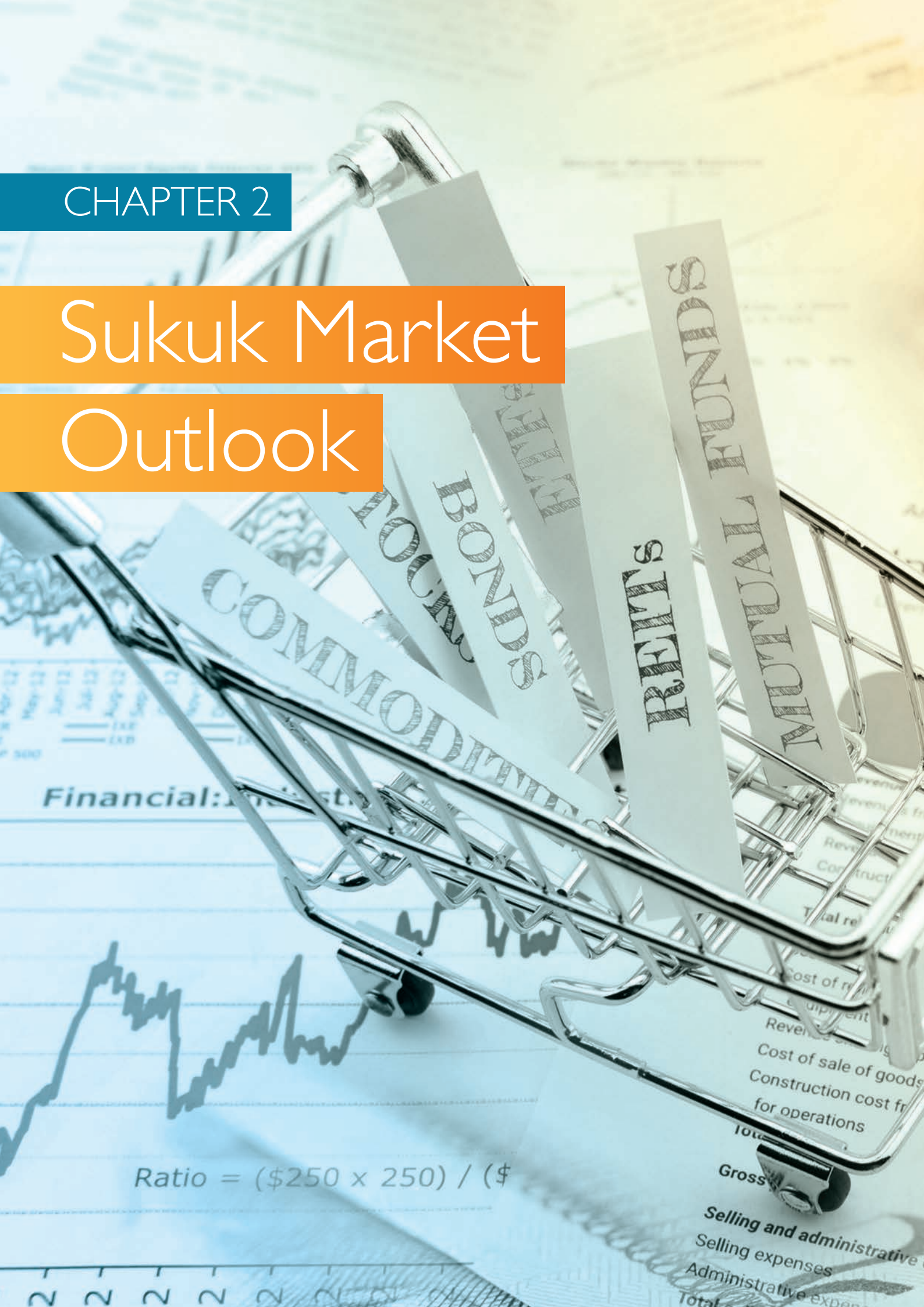
3. <http://www.gulf-times.com/story/486556/Persistent-low-oil-prices-may-dampen-GCC-insurance>.

### UAE TOP 3 TAKAFUL OPERATORS FINANCIAL PROFILE (FYE 2015)

Company	Total Assets (US\$ Mn)	Gross Contributions Written (US\$ Mn)	Net Income (US\$ Mn)	Return on Assets	Return on Equity
Islamic Arab Insurance (Salama)	915	254	(47)	-3%	-10%
Dubai Islamic Insurance and Reinsurance (Aman)	313	116	1	0%	1%
Abu Dhabi National Takaful	190	81	11	6%	18%

## CHAPTER 2

# Sukuk Market Outlook



Financial: Investment

$$\text{Ratio} = (\$250 \times 250) / (\$$$

Gross  
Selling and administrative  
Selling expenses  
Administrative expenses  
Total



Annual Report  
Income Statement  
Public Company

The Agreements  
expenses  
3(b)

600,261  
83,548,776  
5,780,726

# Sukuk Market Outlook

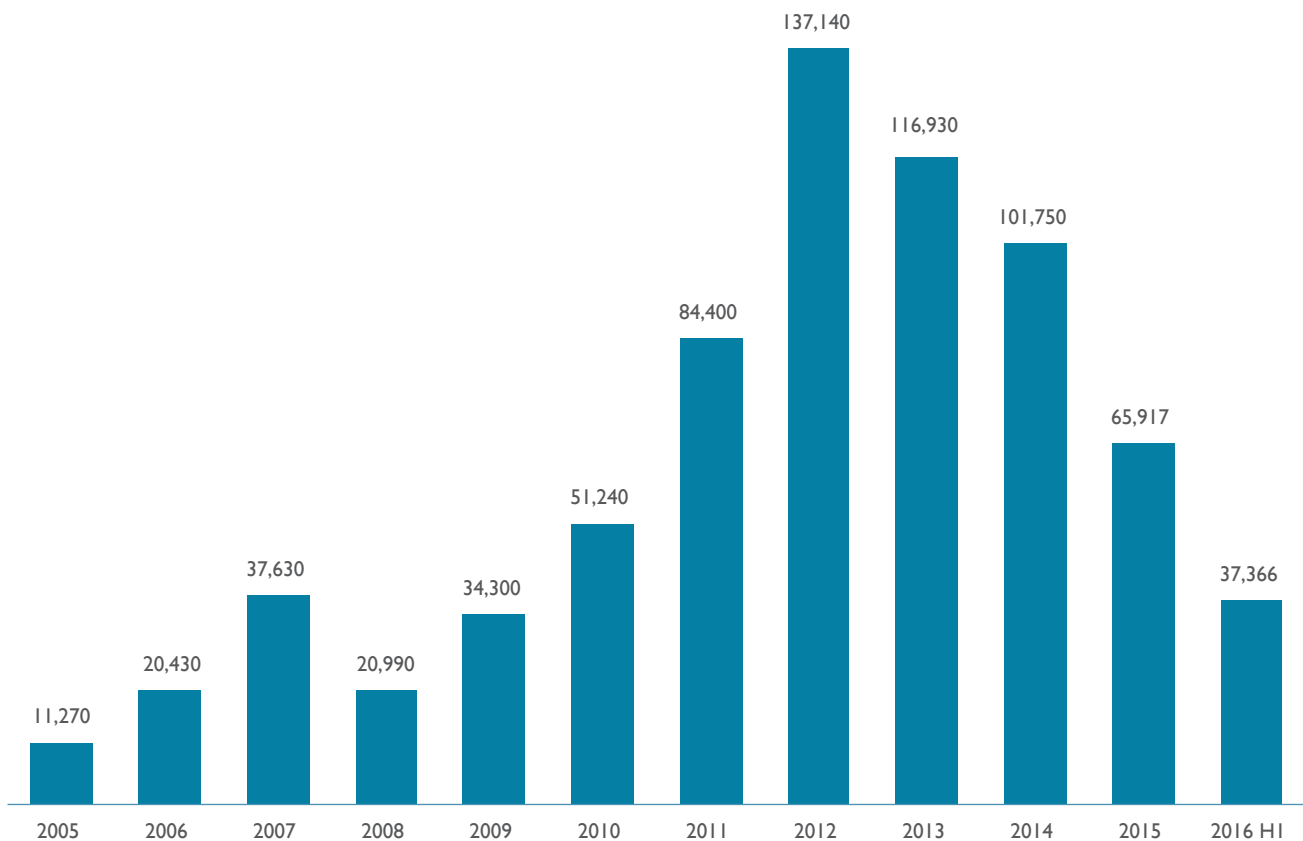
## Global Sukuk Markets Outlook

*Global sovereign sukuk issuances are down significantly since BNM has ceased issuing short-term sukuk and the GCC economic downturn*

Financial institutions and governments issued the first Sukuk at a time that growing Shariah-sensitive financial institutions needed Shariah-compliant investments to absorb their surplus liquidity. Despite the huge growth of the sukuk market in the past 20 years, this is still an issue for financial institutions, given the limited supply of sukuk relative to demand. The entry of conventional fixed-income investors to the market has limited the supply available for investors with a mandate to invest only in Shariah-compliant instruments.

Sukuk have universal appeal for all types of issuers, with a strong captive demand base from Islamic financial institutions. Recently, high-profile issuances by non-Muslim sovereigns have catapulted sukuk into the big leagues of finance, earning global visibility despite their very modest size in absolute terms. Sukuk issuances started growing in 2005 after the increase in oil prices around the world. Issuances accelerated from US\$11.3 billion in 2005 to US\$37.6 billion in 2007, before declining after the financial crisis in 2008. However, it did not take long for the market to recover. In 2010, sukuk issuance passed the US\$50 billion mark. In 2012, with quantitative easing in full force, the sukuk mar-

GLOBAL AGGREGATE SUKUK HISTORICAL TREND (US\$ MN, 2001 – 2016 HI)



ket became a financing vehicle for Islamic and conventional issuers from all over the world, reaching the highest annual total of sukuk issuance to date of US\$137.1 billion. Sukuk issuance decreased slightly to US\$116.93 billion in 2013 and to US\$101.7 billion in 2014.

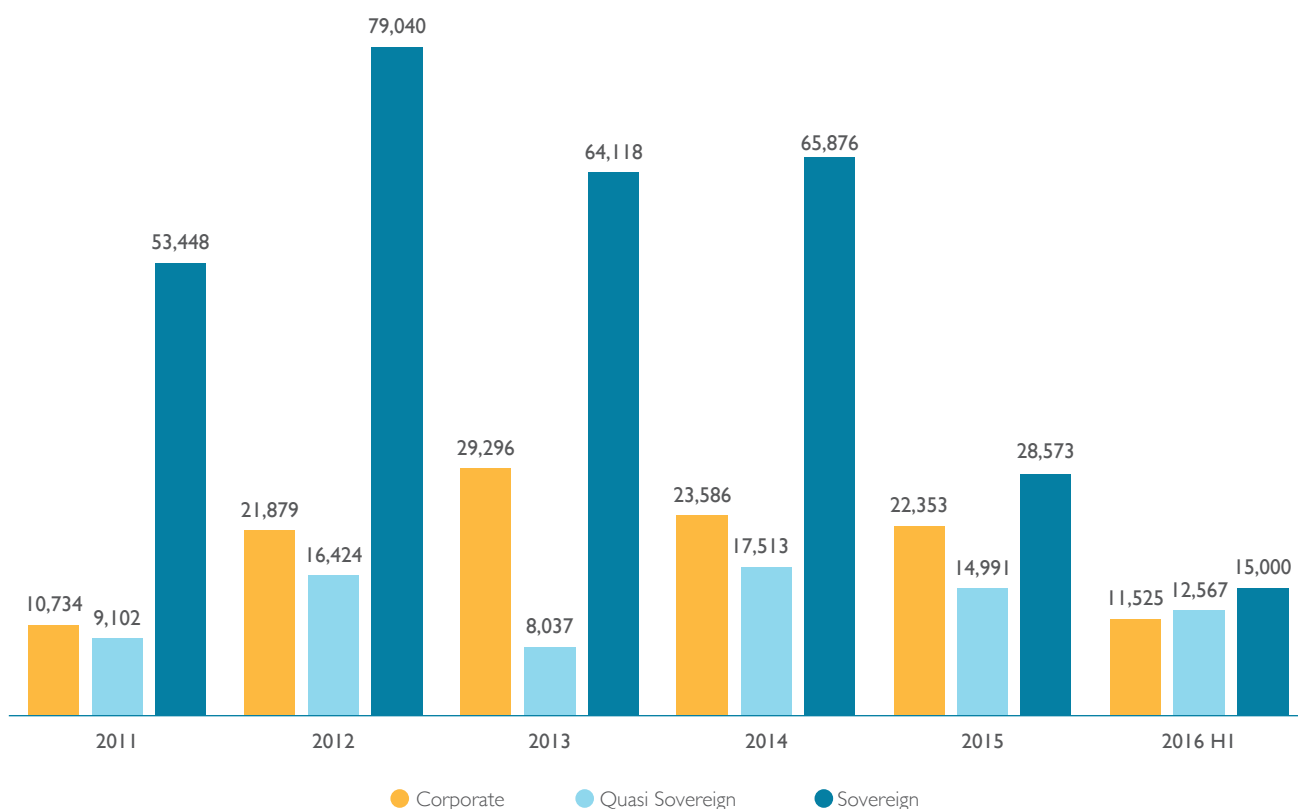
The sukuk market passed milestones every year between 2012 and 2014, as it continued to grow and to move from traditional to non-traditional markets. Having attained a peak in new issuances of \$137.14 billion in 2012, the annual value issued dropped slightly in 2013. However, there were 834 sukuk issuances in 2013, surpassing the 763 issuances in 2012.

2014 stood out as the best year so far in the international sukuk market, as sukuk issuances started moving out from their traditional markets. A number of non-Muslim countries issued their debut sukuk, including Hong Kong, Luxembourg, South Africa, Senegal, and the United

Kingdom. In addition, a number of corporate issuers from Japan to the Maldives tapped into the markets to capture the high demand for sukuk. The issuance of sukuk by entities in such a large number of non-Muslim countries indicates strong worldwide confidence in sukuk. The year 2014 also witnessed the highest number of jurisdictions issuing sukuk, reaching 19 different jurisdictions, compared to 16 in 2013 and 18 in 2012.

The sukuk market at times shows interesting trends despite its small size. The data proves that the decision of a heavyweight country like the United Kingdom to issue sukuk can influence many other countries, drawing in new sukuk issuers. After the UK sukuk were issued in June 2014, only three months passed before Hong Kong, South Africa, Luxembourg, Japan's Bank of Tokyo-Mitsubishi UFJ, and Goldman Sachs all issued sukuk in September of the same year. It was no coincidence that Hong Kong followed

GLOBAL SUKUK BREAKDOWN BY ISSUER TYPE (US\$ MN, 2011 – 2016 HI)



Source: Thomson Reuters

this flurry of issuances in 2014 with another offering in May 2015.

The sukuk business has slowed in 2015 and 2016 on the back of challenging economic conditions in the GCC and Southeast Asia. Although every region has its unique issues, uncertainty in commodity prices and the expected increase in global interest rates has put pressure on governments everywhere, when deciding how to finance their operations. In terms of volume, total sukuk issued in 2015 continued to struggle, dropping a drastic 35.2% to \$65.9 billion from \$101.8 billion in the year before. The sukuk market in 2016 has maintained a similar pace as 2015, and issuances are expected to be in the range of \$65-\$70 billion.

The sukuk industry still continues to depend heavily on government issuances to drive the market, but there has been a notable drop in sukuk issued by governments globally. The drop in sovereign sukuk mainly reflects Malaysia's decision to stop issuing short-term paper, and to a lesser extent, a drop in Saudi Arabian issuance. Total sovereign issuances stood at US\$15 billion by the end of H1 2016, of which US\$8 billion (53.3%) originated in Malaysia. Indonesia has also shown revived sukuk activity and issued US\$2.8 billion in the first half of 2016, representing about 19% world market share. The Indonesian government is expected to see increased issuances in the coming few years to finance infrastructure projects.

Quasi-sovereign sukuk have picked up in H1 2016 to US\$11.5 billion, slightly below total issuances in H1 2015 in this category of US\$15 billion. The quasi-sovereign issuances in Malaysia are rising significantly; 84% of such issuances in H1 2016 occurred in the country. The remaining 16% was in two issuances by the Islamic Development Bank in Saudi Arabia.

Corporate issuers are still shy, and total issuance by corporations at the end of H1 2016 stood US\$11.9 billion. At this pace, private sector issuances will reach approximately US\$24 billion for 2016, which will exceed 2015's volume of US\$22.4 billion. Notable issuances this year have occurred at GCC based banks that have issued tier 1 sukuk to comply with Basel

III requirements, such as Dubai Islamic Bank (US\$500 million), Abu Dhabi Islamic Bank (US\$1,000 million), Noor Bank (US\$500 million), and Bank Al Jazira (US\$533 million). GCC corporations have outperformed other regions in corporate issuances, holding a global market share of 49.5% in H1 2016.

#### *Malaysian government sukuk grow while GCC governments remain almost non-existent in the first six months of 2016*

Malaysia remains the biggest and most liquid national sukuk market, holding roughly a 50% market share of all issuances, totalling \$34.0 billion by the end of 2015. This dominance is a result of decades of effort exerted by the Malaysian government and its regulatory bodies Bank Negara Malaysia (BNM) and the Securities Commission (SC). The country has increased its sukuk volume to US\$22.1 billion in the first six months of 2016, outpacing 2015, with a faster pace of issuances from the government for funding new projects. The absolute decline in recent years resulted from Malaysia's decision to cut back on the issuance of short-term sukuk from Bank Negara Malaysia (BNM), the country's central bank. BNM explained the change, stating that much of this short-term paper was not reaching local Islamic banks. Satisfying these banks' liquidity needs was the program's primary objective, and BNM said a much wider investor base was picking them up. Moving forward, the central bank will be using different instruments that will be made available only to Islamic banks.

The UAE and Saudi Arabia have been the second and third largest issuers until H1 2016. Interestingly, in this six-month period, there was only a single sukuk issuance from the UAE government and none from the government of Saudi Arabia. In the UAE, most new issuances came from banks such as DIB and Noor Bank, which issued sukuk to strengthen their capital adequacy ratio in line with Basel III requirements. Sharjah Emirate issued the only government sukuk in the country. Similarly, there were only six issuances in Saudi Arabia, mainly from financial institutions. Other GCC governments issued practically no sukuk, except Bahrain, a country that issues sukuk regularly for liquidity management.

*Malaysian murabaha remains the most issued structure; wakalah is the new trend*

Murabaha sukuk dominate mainly because of the strong preference for this structure by Malaysian issuers. Of the US\$223.4 billion in murabaha issuances from 2011 to H1 2016, US\$207.3 billion (92.8%) were issued in Malaysia. The Malaysian government has announced incentives for issuers using ijarah and wakalah structures through tax deductions, a move to diversify the underlying structures, to attract more GCC investors. Most GCC investors seek to comply with AAOIFI standards, under which they have to hold these sukuk to maturity as they have ruled murabaha a type of debt and thus not tradable unless at par. As a result, GCC investors prefer other structures.

In aggregate figures, the murabaha structure is the most common for sukuk, but other structures such as wakalah are becoming more

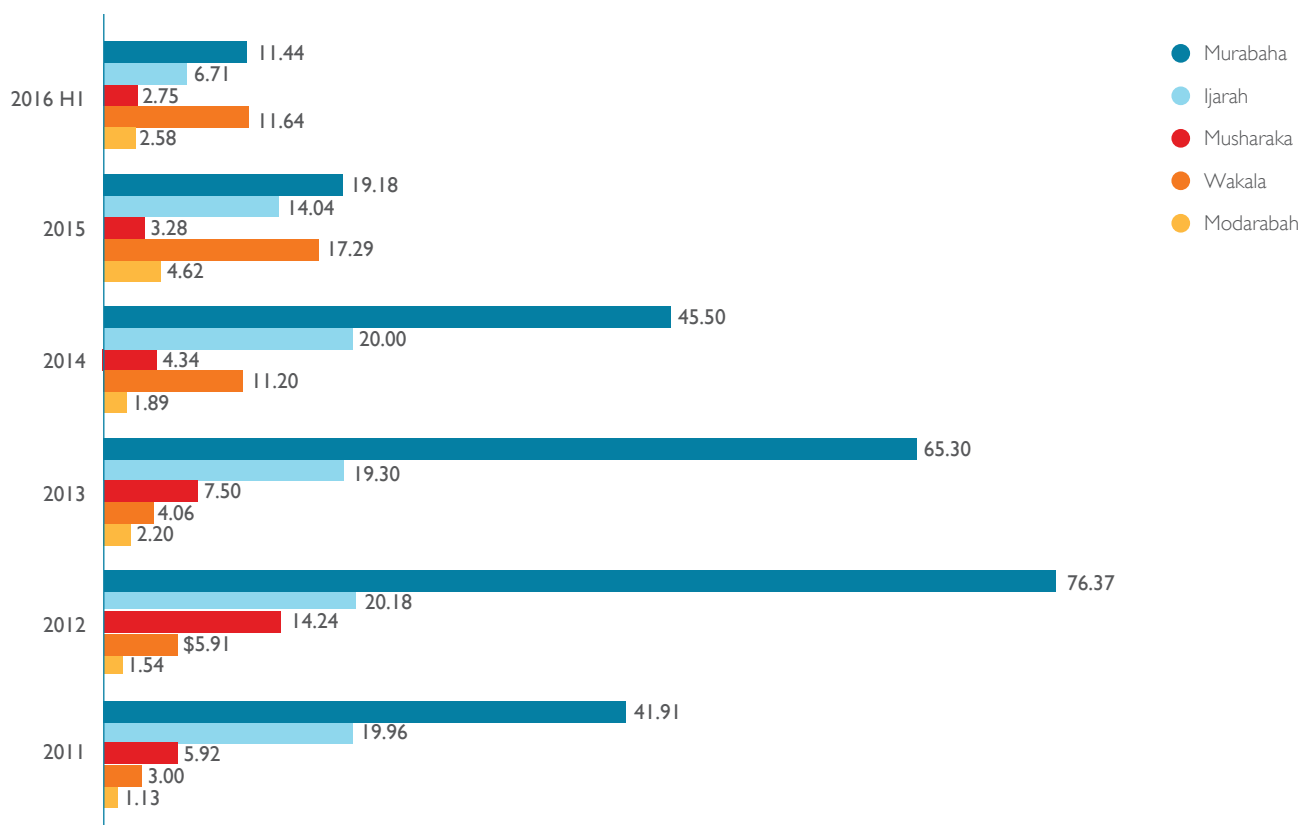
widespread, and they are now favoured by the Malaysian as well as the GCC markets because they may be traded on secondary markets in both. In Malaysia, however, investors can still trade murabaha sukuk in the secondary markets.

In 1H 2016, the wakalah structure continued to be the second most issued structure at US\$10.1 billion, just slightly behind murabaha at US\$11.4 billion. The outlook for the wakalah structure is positive, since banks are increasingly using this structure to issue Basel III sukuk, among other structures such as mudarabah and musharakah.

*Post-Brexit: Sukuk key to funding infrastructure projects in the UK*

In Europe, corporations mainly use Islamic financial products for liquidity management and as an alternative source of funding for investment projects. However, in the UK, Islamic finance

GLOBAL SUKUK TOP FIVE STRUCTURES (US\$ BN, 2011 – 2016 H1)



Source: Thomson Reuters

\* Salam, Istithmar, Bai Dayn, Beieniah, Hybrids and Istisna

has recently been playing an important role in the funding of infrastructure development projects, such as The Shard and the Olympic Village redevelopment. In addition, the UK Trade and Investment Department (UKTI) continues to promote Shariah-compliant funding for UK regeneration projects and developments.

Post-Brexit, the UK stands to lose assigned EU funding for some of its infrastructure and regeneration projects and will therefore be seeking alternative funding sources. The British

government will likely turn to Islamic finance, particularly sukuk, to substitute some lost EU funding, given its growing interest in Shariah-compliant funding. Both in the UK and the EU, infrastructure projects in sectors such as water, energy, transportation, manufacturing and information technology, could potentially be funded with sukuk. Recommended sukuk structures for these projects include: murabaha and salam for the expansion of sector operations, istisnaa for project construction and ijarah for leasing arrangements.

## *GCC Sukuk Market Outlook*

### *Economic Challenges in the GCC Hinders the Growth of Sukuk*

After a solid performance between 2012 and 2014, there were expectations that GCC oil-exporting countries hit by low oil prices would turn to sukuk issuances to cover their budget deficits. However, these expectations were not met in 2015 and 2016.

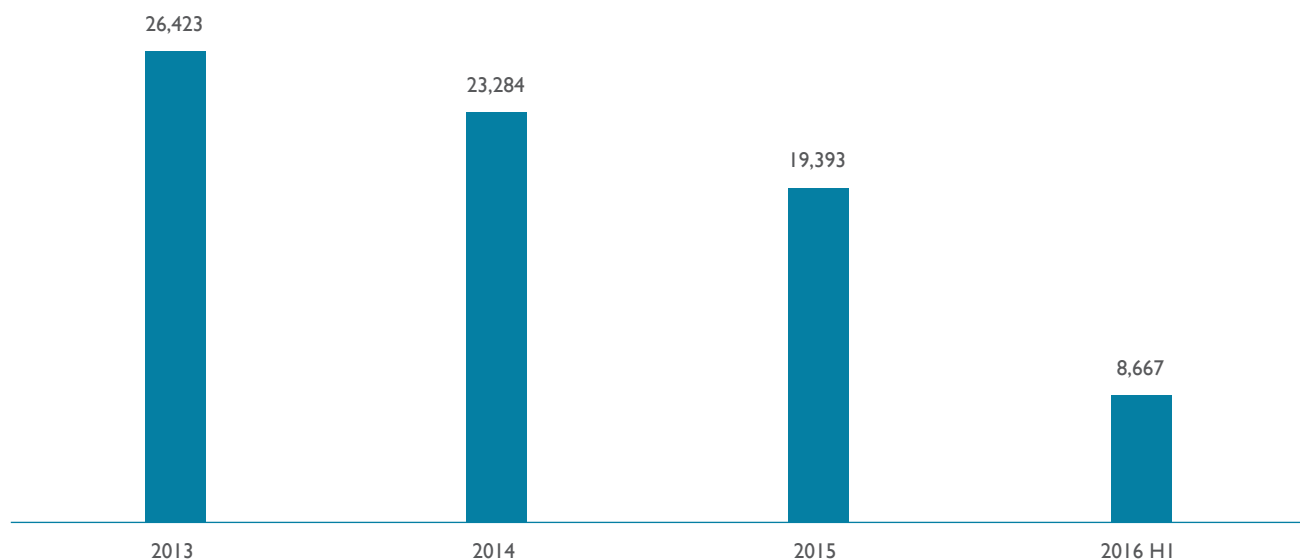
GCC governments were almost totally absent from the sukuk market in the first half of 2016, despite their significant need of additional funding. The only two governments issued were Sharjah and Bahrain, the latter for liquidity management through its regular short term sukuk program. Unlike other regions, GCC countries depend on corporations to maintain volumes in the sukuk market. In the first six months of 2016, of the US\$8.7 billion total sukuk issuances in the GCC, 58.5% came from corporations, 22.4% was quasi-sovereign and 19.1% was sovereign.

### *GCC banks are issuing Basel III-compliant Sukuk*

GCC banks are continuously hunting for new sources of tier I capital to support asset growth as well as to absorb shocks from any unexpected financial and economic events. The new regulatory framework in Basel III requires banks to increase their capital buffers to improve the systemic stability of global finance, in addition to diversifying the structure of these buffers and their quality. A trend towards choosing sukuk to satisfy these new requirements started in 2012, when Abu Dhabi Islamic Bank issued the first Basel III-compliant tier I capital boosting sukuk. The trend is likely to continue in the mid-term in the GCC on the back of a drop in oil prices, which has impacted the overall economic health of the six GCC countries.

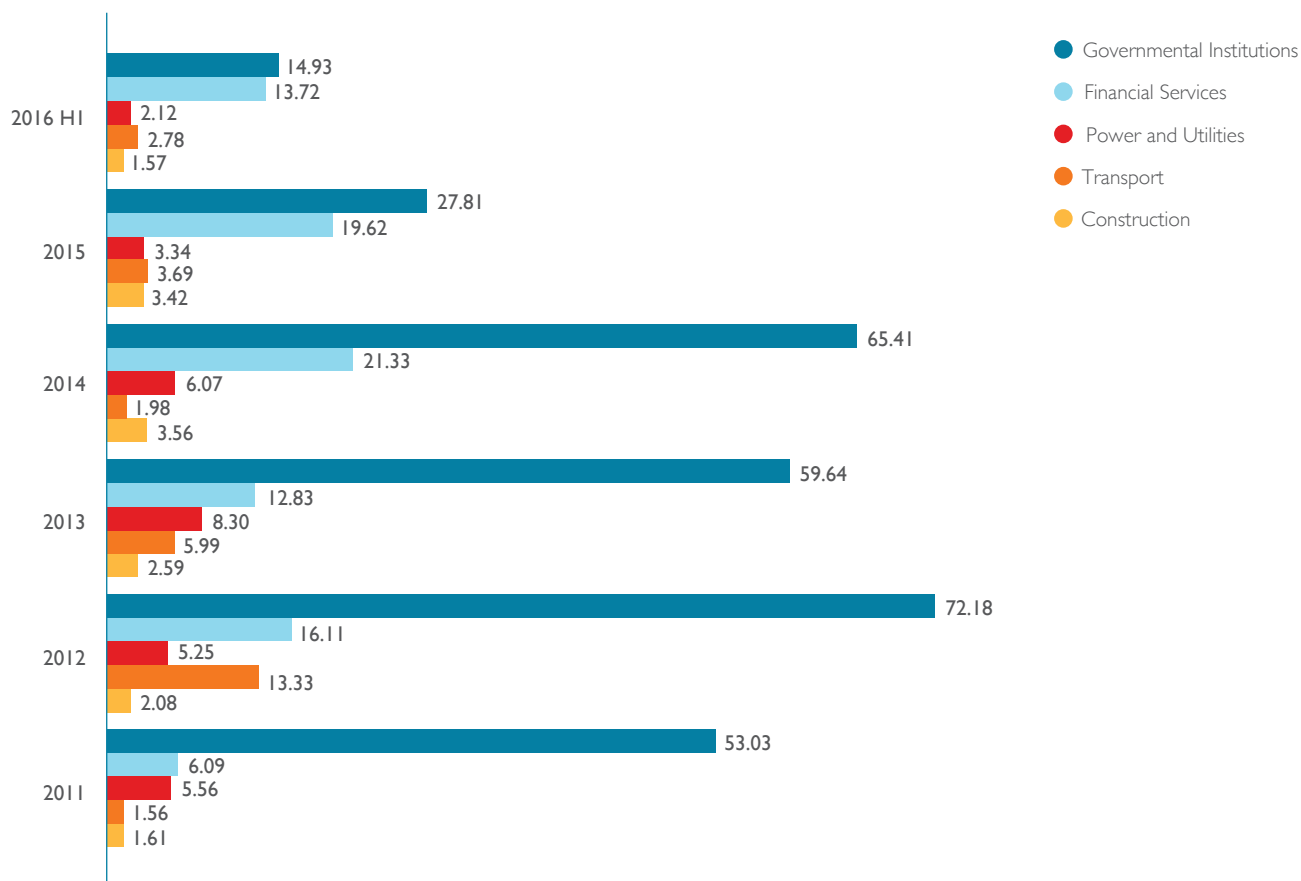


### GCC SUKUK ISSUANCE (US\$ MN, 2011 – 2016 HI)



Source: Thomson Reuters

### GLOBAL SUKUK TOP FIVE SECTORS (US\$ BN, 2011 – 2016 HI)



Source: Thomson Reuters

A photograph of a business meeting. In the foreground, a person's hands are typing on a silver laptop keyboard. To the right, another person's hands are holding a tablet displaying a software interface with various design options like 'INTERIOR DESIGN', 'SOLUTION', and 'WEB DESIGN'. In the background, a person in a suit has their hands clasped. The image has a blue and orange color scheme.

## CHAPTER 3

# Current Islamic Liquidity Management



# Current Islamic Liquidity Management Practices

## Overview

### *GCC banks are primarily focused on investing surplus liquidity*

Banks in the GCC, with consistent capital inflows from oil exports, have seen significant growth in their assets in recent years. As their assets have grown, they have been able to issue bonds and sukuk to expand their capital base as needed, which has limited their reliance on wholesale funding. As a result, liquidity instruments offered by central banks common in the GCC countries are focused on absorbing liquidity from the banking system to manage inflation. Banks are primarily involved in recycling this liquidity through the domestic economy. The currency pegs employed limit the ability of monetary policy to do much beyond main-

taining the exchange rate, which requires other avenues of absorbing liquidity when inflationary pressures build up.

In most of the GCC markets, central banks either have no dedicated Islamic finance tool, or they rely upon commodity murabaha. Where there is no Shariah-compliant tool to absorb liquidity from the Islamic banks, the banks will often deposit some of their excess liquidity with the central bank in the form of reserves, above the mandated level. This provides them access to those reserves if they need them, but it does not offer a return, because the central banks are not engaged in activities generating profits that can be passed through to the banks.

## Commodity-based instruments

### *For Islamic banks, commodity murabaha and similar instruments dominate the existing landscape*

The alternative, employed in Kuwait is to absorb liquidity through tawarruq (reverse murabaha), which acts as short-term treasury bonds.

The UAE also uses commodity murabaha as the basis for their Islamic Certificates of Deposit. In

addition to providing an investment for banks' surplus liquidity for up to one year, the Islamic CDs are usable as a source of liquidity through the Collateralized Murabaha Facility. This facility uses the Islamic CDs as collateral for shorter-term financing of up to three months in a transaction that acts as a repurchase agreement (repo) alternative.

## Other instruments

### *Wakalah placements with other banks and with central banks are becoming more common*

In response to the debt crisis in Dubai, the UAE Central Bank provided liquidity to Islamic banks through perpetual wakalah deposits. It is not known whether the central bank would use this method in response to a future crisis, but it proved effective at rebuilding confidence in the

banks, making it a tool that could legitimately be used again in the future.

Other options besides commodity murabaha include sukuk al-salam at the Central Bank of Bahrain (CBB), in which a commodity (aluminum) structures the equivalent of a 91-day treasury bill where the sale price is paid immediately, with deferred delivery. The CBB also

regularly issues 182-day sukuk al-ijarah, which are sale-and-leaseback transactions in which the banks that buy the sukuk receive certificates that represent tangible assets, rather than financial receivables, making them tradable.

Regular auctions of sukuk al-salam and sukuk al-ijarah securities consistently provide liquid

assets to these banks, although this still falls short of the banks' great demand. In order to address the shortage, in 2015, the CBB announced a wakalah instrument that will allow retail Islamic banks to deposit their surplus liquidity with the central bank on a one-week tenor that will be invested on the banks' behalf in instruments including sukuk.<sup>4</sup>

### International instruments

*The dollar peg gives Islamic banks an opportunity to enter the international sukuk market*

Finally, given the currency peg with the US dollar in most GCC countries except Kuwait, the International Islamic Liquidity Management Corporation (IILM) sukuk provides another short-term instrument for Islamic banks to invest their surplus liquidity. The IILM sukuk, which are issued with three-, four- and six-month tenors, use an asset-backed commercial paper structure in which a long-term sukuk acts as the underlying asset.<sup>5</sup> That sukuk is issued to the SPV set up by the IILM for a country with a sufficiently high credit rating (or credit uplift from a development bank guarantee) in an ijarah transaction with a five-year term. The SPV then issues short-term sukuk to primary dealers to finance the long-term sukuk. These primary dealers sell the sukuk into the market,

and they act as market makers for the sukuk to ensure continuous liquidity. Central banks may also use IILM sukuk to offer liquidity instruments denominated in domestic currencies for local banks that need liquidity in these currencies. For example, if the central bank is able to buy the A-I rated IILM sukuk, it can hold it and issue local currency sukuk with the same maturity against the IILM sukuk.

Matching the maturity of its newly issued liabilities with the asset it holds against those liabilities limits the risk to the central bank. It provides the local banking system with central bank guaranteed assets that count as high-quality liquid assets under the Basel III rules, alleviating some of the supply shortages that have impeded Islamic banks' transition to Basel III compliance.

4. Torchia, Andrew. "Bahrain launches wakala liquidity tool for Islamic banks," Reuters, April 1, 2015. <http://www.reuters.com/article/bahrain-islam-financing-idUSL6N0WYISQ20150401>

5. Vizcaino, Bernardo. "Islamic finance body IILM auctions first four-month sukuk," Reuters, August 18, 2016. <http://af.reuters.com/article/nigeriaNews/idAFL8N1AZ05X>

## Issues affecting the tradability of Sukuk






Although sukuk can be issued using 14 different structures so far that have received Shariah approval from the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), not all of these structures can be traded in the secondary markets under Shariah rulings. For example, murabaha sukuk are not a tradable structure except at par because after the origination, the certificates represent a debt receivable. The same restrictions apply to salam and istisna'a (depending on whether there is a tangible asset built to a usable stage under the istisna'a).

Other sukuk, such as wakala, mudaraba, musharaka and ijara are tradeable because the certificates represent either full ownership of the underlying tangible assets or business or ownership of those assets. For example consider an ijara sukuk issued by a company where beneficial ownership is sold to an SPV which funds the purchase by issuing sukuk certificates. After the Sukuk are issued and the asset beneficially owned by the SPV leases back the asset to the originator, the sukuk certificates represent a beneficial ownership interest in the underlying asset as well as the right to the cash flows generated by that asset.

For a wakala, mudaraba or musharaka sukuk, where the underlying assets are often a mix of other financial assets (murabaha, salam, istisna'a, ijara, mudaraba, musharaka). Whether or not the wakala sukuk are tradable depends on the underlying assets' tradability but there is a difference of opinion from a Shariah perspective on the threshold. AAOIFI's Shariah board permits trading if the sukuk is represented by at least 33% tangible assets while the OIC Fiqh Academy requires a minimum of 51%.

## Liquidity Management Landscape

### Liquidity Programs and Instruments Issued By Respective Central Banks in GCC

 Category	 Country	 Product	 Tenor	 Liquidity
Liquidity instruments	Kuwait	Tawarruq with Central Bank	3 and 6 months	Not tradable
	UAE	Islamic Certificates of Deposit	1 week – 1 year	Not tradable
	Global	IILM Sukuk	3-, 4- and 6-month	Tradable
	Bahrain	Sukuk al-Salam	91 days	Not tradable
	Bahrain	Sukuk al-Ijarah	180 days	Tradable
	Bahrain	Wakala	1 week	Theoretically tradable, not traded in practice
	All	Central bank reserves	Overnight – 1 year (not all central banks offer returns)	Not tradable
Liquidity programs	UAE	Collateralized Murabaha Facility	Overnight – 3 months	Not tradable
	UAE	Wakala deposits by central bank in Islamic banks	Perpetual	Not tradable

Source: Central bank websites and Thomson Reuters. "Survey of Characteristics of Short Term Financial Instruments Used By Islamic Banks," Presentation delivered at the IILM Roundtable on Liquidity Management, 16 April 2015, Washington, DC.

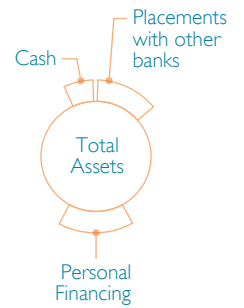
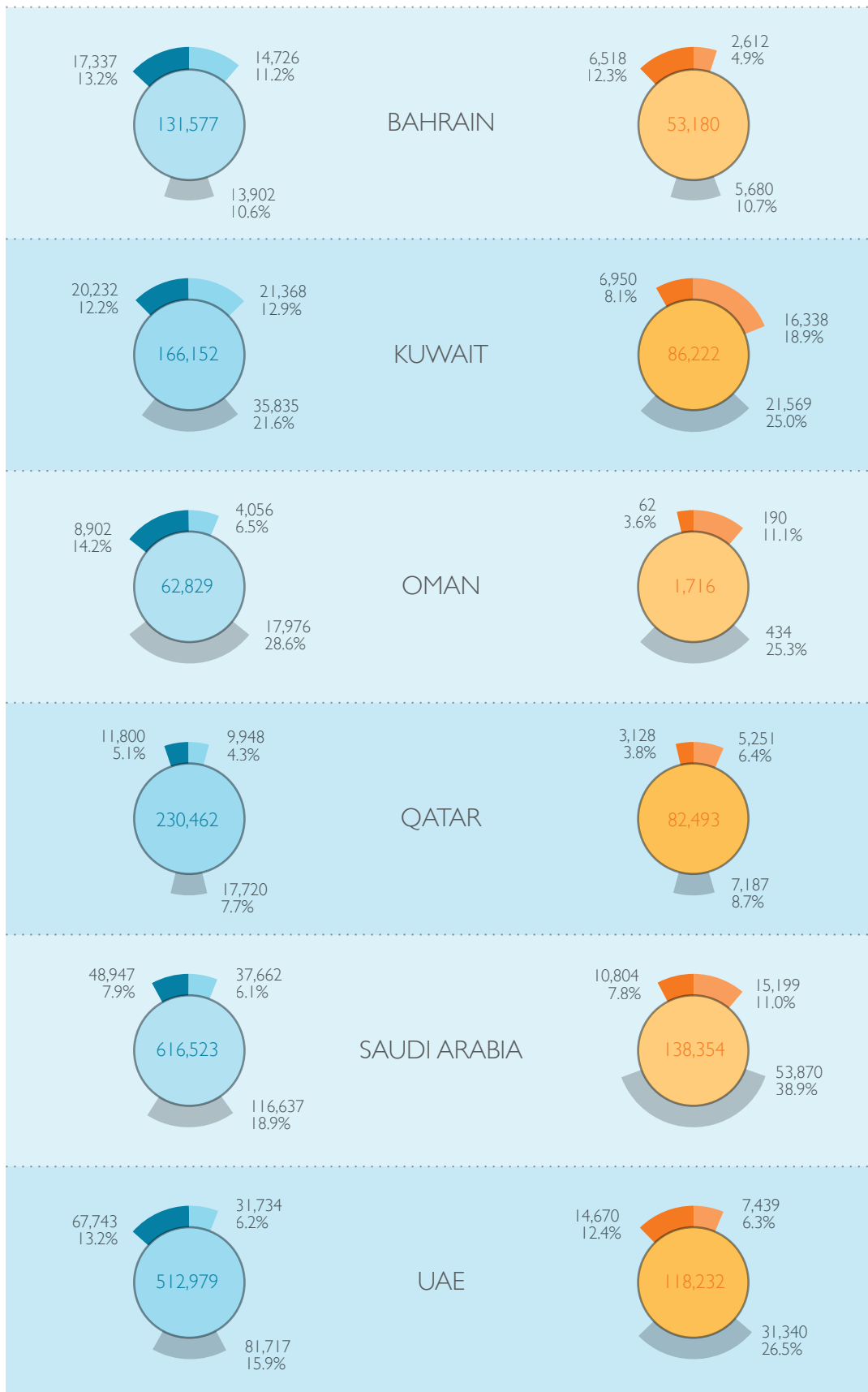
## GCC Banks Liquid Assets and Personal Financing

### Conventional and Islamic Banks

(US\$ MN, FYE 2015)

### Islamic Banks

(US\$ MN, FYE 2015)



Note: Sample includes 36 conventional banks and 39 Islamic banks and Islamic banking subsidiaries



CHAPTER 4

Commodity

Murabaha and the

Islamic Interbank

market in the GCC





# Commodity Murabaha and the Islamic Interbank market in the GCC

## Market overview

### *Islamic banks hold more liquidity than their conventional counterparts*

Across the financial sector in the GCC, the primary point of concern for banks is investing excess cash with sufficient yields. This is true both for conventional banks and for Islamic banks. Neither are highly reliant on wholesale funding; outstanding wholesale funding represents 8.2% of total assets, less than current cash holdings. Any local regulatory impetus toward conservative balance sheets is likely to be reinforced by Basel III rules, which set more stringent requirements on funding stability and unfavorably treat wholesale funding in calculations of net stable funding ratios.

The primary difference between Islamic and conventional banks is in the split in their liquid assets between cash or central bank reserves and placements with other financial institutions. For conventional banks, the split in liquid assets between cash and equivalents and placements is 60%/40%, while at Islamic banks it is 47%/53%. The difference varies between markets because of the inclusion of treasury bill holdings at conventional banks in all markets, while options for Shariah-compliant treasury bills are limited.

In addition to the discrepancy between Islamic and conventional banks' holdings of cash and equivalents versus interbank placements, the overall liquid asset buffer at Islamic banks is higher. Across the GCC countries, Islamic banks

hold 18.6% of their assets in liquid assets while conventional banks hold 16.6%. Although this seems like a small difference, it could affect profitability at Islamic banks because 2% of total assets of the banks included in our sample represents nearly US\$10 billion.

Within the UAE, Islamic banks hold significantly higher levels of cash and equivalents relative to their placements with other financial institutions. Unlike elsewhere in the GCC, where fewer products offer competitive ways to invest these funds, the Central Bank of the UAE offers an Islamic Certificate of Deposit that provides higher yields. It also facilitates much greater liquidity than in other countries with a repo alternative through its Collateralized Murabaha Facility.

The introduction of these products puts Islamic banks in a much stronger position because they can hold cash and cash equivalents without sacrificing profitability relative to their conventional competitors. Regarding their equivalent liquidity strategies, Islamic banks in the UAE are less reliant on wholesale funding than their conventional competitors, although both have more than enough liquidity to cover their wholesale funding liabilities multiple times over.

## LIQUIDITY AND INTERBANK PLACEMENTS FOR GCC BANKS (% OF TOTAL ASSETS)

	Cash and equivalents	Placements with other financial institutions	Total
All banks	10.2%	6.9%	17.1%
Conventional banks	10.7%	5.8%	16.5%
Islamic banks	8.8%	9.8%	18.6%

Source: Bank financial statements

Note: Sample includes 36 conventional banks and 39 Islamic banks and Islamic banking subsidiaries

## LIQUIDITY AND INTERBANK PLACEMENTS FOR UAE BANKS (% OF TOTAL ASSETS)

	Cash and equivalents	Placements with other financial institutions	Total
All banks	13.2%	6.2%	19.4%
Conventional banks	13.4%	6.2%	19.6%
Islamic banks	12.4%	6.3%	18.7%

Source: Bank financial statements

Note: Sample includes 10 conventional banks and 6 Islamic banks and Islamic banking subsidiaries

### Impact and future opportunities

*Even where similar liquidity positions exist, Islamic banks may be disadvantaged by higher costs*

A working paper published by the IMF in 2015 showed that Islamic banks consistently underperformed their peer conventional banks in terms of returns on equity from 2008 to 2013. Falling profitability at conventional banks in 2014 eliminated the gap, at least for that year.<sup>6</sup> The figures above about the relative earnings opportunities for Islamic banks' liquid assets deal with cash and equivalents and interbank placements as if Islamic banks had equal opportunities for earnings as conventional banks. However, the costs associated with structur-

ing commodity murabaha transactions have a disproportionate impact on profits in a low interest rate environment.

The brief overview provided above of the interbank financing markets in the GCC suggests clearly that there is room for alternative products to commodity murabaha but that they need to address two factors to be successful: 1) they need to deliver returns competitive not just to commodity murabaha but also to conventional money markets; and 2) they need to improve upon the execution costs of commodity murabaha. The alternative is to develop sovereign instruments, which are discussed in the next section.

6. Basu, Ritu, Ananthakrishnan Prasad and Sergio Rodriguez. 2015. "Monetary Operations and Islamic Banking in the GCC: Challenges and Options," *IMF Working Paper WPI/15/234*.

## INTERBANK FINANCING PRODUCTS USED IN THE GCC

Country	Product	Tenor	Liquidity
GCC countries except Oman	Commodity murabaha/tawarruq	ON – 1 year	Not tradable
Kuwait	Compensating mutual balances	Perpetual	Not tradable
GCC countries	Interbank mudaraba	ON – 1 year	Theoretically tradable, not traded in practice
GCC countries	Interbank wakala	1-3 months	Theoretically tradable, not traded in practice

Source: Central bank websites and Thomson Reuters. "Survey of Characteristics of Short Term Financial Instruments Used By Islamic Banks," Presentation delivered at the IILM Roundtable on Liquidity Management, 16 April 2015, Washington, DC.

### Alternatives to Commodity Murabaha

#### *Wakalah arrangements and murabaha using non-commodity assets serve as an alternative to commodity murabaha*

The most relevant alternatives at GCC Islamic banks for the interbank market besides commodity murabaha are compensating mutual balances, interbank wakalah and the NASDAQ Dubai murabaha platform. In compensating mutual balances, banks place funds with one another; each bank has their net position cross zero at least once within a certain time period, ensuring interbank liquidity but generating no return. Interbank wakalah has been used most widely in Oman as a replacement for

commodity murabaha. Because commodities are not sourced to back the transactions, they are cheaper in theory. However, there are issues relating to the status of wakalah in bankruptcy and the returns cannot be guaranteed ex ante, limiting its appeal where regulators allow and banks can choose commodity murabaha where regulators allow commodity murabaha.<sup>7</sup> Wakalah also limits the signaling value of interbank murabaha for monetary policy because the ex post nature of the profit calculation means the anticipated rates are more likely to diverge from the realized returns for longer tenor financing agreements.

7. Alvi, Ijlal Ahmed. 2014. "IIFM Interbank Unrestricted Master Investment Wakalah Agreement," Presentation delivered at the IIFM Industry Seminar on Islamic Capital and Money Market, Jakarta, Indonesia, 6 May 2014. [http://www.iifm.net/sites/default/files/session-files/IIFM%20Interbank%20Unrestricted%20Master%20Investment%20Wakalah%20Agreement%20by%20Mr.%20Ijlal%20Ahmed%20Alvi\\_0.pdf](http://www.iifm.net/sites/default/files/session-files/IIFM%20Interbank%20Unrestricted%20Master%20Investment%20Wakalah%20Agreement%20by%20Mr.%20Ijlal%20Ahmed%20Alvi_0.pdf)

## Potential size and growth trends

### Overview

*A combination of existing market structures show the likely path for Islamic interbank markets*

The future for GCC Islamic financial institutions will be strongly affected by the regulation and structuring of Islamic banks within the wider financial sector. If the regulatory environment follows the example set in Qatar, where conventional banks are prohibited from operating Islamic windows, Islamic banks will shift towards Islamic liquidity management instruments that increase their ability to place more of their surplus liquidity with other banks or with the central bank.

### Qatar

*Smaller domestically focused Islamic banks experience similar liquidity flows*

Among the sample of countries shown below, Qatari Islamic banks held the least amount of cash and equivalents as a share of their assets, except for banks in Oman. Most of the Qatari Islamic banks' liquid assets were placed at other financial institutions. In Qatar, for example, the government previously issued treasury bills to absorb surplus liquidity, but more Islamic banks now tap wholesale markets as liquidity has dried up. In a market where Islamic banks operate mostly as stand-alone entities, their balances of liquid assets will likely be either mostly in surplus or mostly in deficit at any given time.

This will occur because Islamic banks in Qatar tend to be smaller and more domestically focused than conventional banks, and their liquidity needs will follow the local markets. For Qatar, this meant surplus liquidity when energy prices were high and deposits were rising faster than financing and a shift towards deficits when energy prices fell and financing growth grew faster than deposits.

### Oman

*Separation of Islamic and conventional banks limit the need for commodity murabaha*

The same situation is evident in Oman, where the introduction of Islamic banking occurred alongside a near-total ban on using commodity murabaha and a ban on Islamic windows. Instead, Oman required conventional banks entering the Islamic finance markets to set up separate Islamic banking subsidiaries, which compete with two standalone Islamic banks. Without the ability to use commodity murabaha to place funds with conventional banks, there was a bigger market impetus for an Islamic interbank market to develop, which emerged with the use of wakala.

### UAE

*Commodity murabaha is more useful in diverse banking systems with Islamic banks and windows*

By contrast, in markets where institutional forms are more diverse, such as the UAE, there will be more use for commodity murabaha alongside other liquidity management instruments. When Islamic banks face a market with a mix of standalone Islamic banks and conventional banks with Islamic windows, they will need to place funds with and receive funds from conventional banks in addition to Islamic banks. Because the subject of a commodity murabaha transaction is a Shariah-compliant asset, and not the counterparty's balance sheet, Islamic banks can use commodity murabaha to place funds with conventional banks. They are unable to use other financing tools such as wakala with conventional banks, because this would involve financing and profiting from non-Shariah compliant activities, which is strictly prohibited.

## Malaysia

### *Commodity murabaha features in this mature market with a mix of Islamic banks and subsidiaries*

Malaysia offers an instructive way to measure the future prospects for Islamic liquidity management, which combines some of the insights from the two examples given below. However, Malaysia's example is not entirely representative of the future for GCC Islamic banks.<sup>8</sup>

By virtue of having a centralized Shariah Advisory Council at the central bank and a more flexible position regarding the trading of debt relative to the GCC countries, Malaysia's interbank market has been able to develop many of the tools needed to facilitate flow of liquidity between Islamic financial institutions. The central bank has therefore been able to use instruments that would not be possible to use in the GCC because trading of debt is more limited.

Despite these limitations on product transferability, the end result in the financial statements of Malaysian Islamic banks has increasingly close parallels with the interbank market in the GCC as the product development matures. In Malaysia, conventional and Islamic banks use interbank

markets at an almost equal rate. Islamic banks held a slightly lower percentage of their assets in liquid form than conventional banks and held very few cash and equivalents (RM 1.3 billion against combined assets of RM 535 billion).

This suggests there is no liquidity hoarding as a result of concerns about the availability of liquidity instruments from the central bank. It also reflects the connection that most of the Islamic banking subsidiaries have to conventional banking parent companies that can supplement their needs for liquidity. This view is confirmed when looking at the standalone Islamic banks, Bank Islam and Bank Muamalat, where the situation is nearly reversed.

The standalone Islamic banks also show no indication of liquidity hoarding with cash and due from financial institutions representing 6.0% and 3.6% of their total assets, respectively. Of these amounts, the majority is held in the form of cash and equivalents reflecting their ample opportunities to invest surplus liquid assets.

8. The Islamic Interbank Money Market products are described in detail on Bank Negara Malaysia's microsite for the Islamic Interbank Money Market (IIMM), available from <http://iimm.bnm.gov.my/index.php?ch=4&p-g=4&ac=22>. Products using bay' al-dayn and hibah are unlikely to be applicable in the GCC.

## LIQUID ASSETS AT BANKS IN MALAYSIA (% OF TOTAL ASSETS, 2015)

	<b>Cash and Equivalents</b>	<b>Due from Financial Institutions</b>	<b>Total Liquid Assets</b>
Conventional Banks	3.4%	10.9%	14.3%
Islamic Banks	0.4%	9.5%	9.9%
All Banks	2.8%	10.6%	13.3%

Source: Bank Negara Malaysia and Thomson Reuters analysis

## LIQUID ASSETS AT STANDALONE ISLAMIC BANKS IN MALAYSIA (% OF TOTAL ASSETS, 2015)

	<b>Cash and Equivalents</b>	<b>Due from Financial Institutions</b>	<b>Total Liquid Assets</b>
Bank Islam	5.8%	0.2%	6.0%
Bank Muamalat	3.1%	0.4%	3.6%
All Islamic Banks	0.4%	9.5%	9.9%
All Banks	2.8%	10.6%	13.3%

Source: Bank Negara Malaysia, bank financial statements and Thomson Reuters analysis

## The future of interbank markets

### *Operational efficiencies call for the continued use of murabaha*

In order to translate current conditions in Malaysia Islamic banking to projections and recommendations for the GCC, there are a few considerations. First, the GCC economies are less diversified than Malaysia's and are more reliant on commodity exports at the present time. This means that banks will continue to need to find avenues to invest surplus liquidity. Because most banks are domestically focused, liquidity will be cyclical, and absorbing this liquidity will fall largely on the central bank and/or government. In order to maintain a level playing field, there is a very strong case for Islamic treasury bills (such as the tawarruq used in Kuwait or short-term sukuk issued in Qatar) or certificates of deposits (as used in the UAE).

Islamic windows at conventional banks will not likely develop separate cash management departments, but instead, they will have assets segregated within their parent bank's cash

management department. This will include placements with other financial institutions using commodity murabaha, because it offers the most flexibility and will fit the easiest within existing cash management systems.

Standalone Islamic banks will have to look to government Islamic T-bills, Islamic CDs, or other instruments to place most of their surplus liquidity. Some of the remainder will be held on balance sheets as cash in order to manage unexpected shocks because of a smaller set of central bank instruments compared to Malaysia. A portion of the assets they hold today as cash will be shifted to interbank placements in order to generate yields. However, given the cyclicity of excess liquidity in GCC banks, there will probably be a continued reliance on commodity murabaha, which amounts to an effective outsourcing of some of the cash management responsibilities at Islamic banks to Islamic windows, which have a deeper set of options and more access to international liquidity management instruments.

## Murabaha will see improvements

### *Process improvement can enhance the authenticity of murabaha and connect it to the real economy*

Surveying these trends in Islamic interbank markets, it is clear that there is unlikely to be an alternative instrument that can fully displace the role that commodity murabaha plays. Although many industry stakeholders, including consumers and some Shariah scholars, may view this determination in a negative light, it does not mean current practices are likely to persist. Indeed, they have already begun changing.

In addition to improvements made to the process used for commodity murabaha, to make the transactions easier to manage and audit, there have been improvements that better connect the commodities and transactions to the markets where the interbank transactions occur. For example, the Dubai Multi-Commodities Centre (DMCC) Tradeflow platform allows for commodity murabaha transactions to trade

physical commodities located within the UAE and stored in halal-certified warehouses, using Shariah-compliant warehouse receipts.

Two other similar examples are the Bursa Suq al-Sila' in Malaysia and the Jakarta Futures Exchange (JFX) Shariah which offer multi-commodity trading platforms that address many of the procedural Shariah issues relating to tracing ownership of the underlying commodities. It also provides the option for the parties involved to take delivery of the commodity within seven days, if they choose.<sup>9</sup>

Their limitation of these products is that they maintain the use of unrelated commodities to structure financing transactions, which increases both the fees connected with the exchanges relative to conventional loans. A different approach is to find an alternative to the underlying commodity, as most of the costs of a commodity murabaha accrue from commodity brokers fees and price spreads.

9. Dusuki, Dr. Asyraf Wajdi, Mohammad Mahbubi Ali and Dr. Yulizar D. Sandrego. 2013. "The Application of Commodity Murabahah in Bursa Suq Al-Sila' Malaysia vis-a-vis Jakarta Future Exchange Shariah Indonesia: A Comparative Analysis," ISRA Research Paper No. 49/2013.



## A shift away from commodities

### *New approaches employed in the UAE shift towards sukuk as the underlying asset*

A new approach developed in the UAE by the NASDAQ Dubai and Emirates Islamic Bank is a murabaha trading platform.<sup>10</sup> It uses a basket of Shariah-compliant securities including sukuk, private equity and real estate held in NASDAQ Dubai's Central Securities Depository against which wakala certificates are issued.<sup>11</sup> Each of these wakala sukuk represents an undivided ownership interest in the underlying pool of assets, which can be used to execute commodity murabaha transactions between financial institutions and between a financial institution and its customer.

National Bonds Corporation has developed another alternative murabaha platform using already existing mudaraba sukuk created for its retail savings program, which has over 900,000 customers. The National Bonds sukuk trading platform operates similarly to the NASDAQ Dubai murabaha platform, but the underlying asset is a mudaraba sukuk backed by infrastructure assets located in the UAE. The Sukuk Trading Platform therefore offers similar cost

benefits but uses a more standardized asset with wide market recognition.

The standardized asset pool, which backs both the Sukuk Trading Platform and the National Bonds issued to the retail market, builds on an already existing platform, which allows the operational costs to be spread over a wider asset base. It also brings an electronic transfer system, which allows the customer receiving financing to receive delivery of their sukuk by SMS. During the period between receiving the sukuk and redeeming them with National Bonds, they have an identifiable and unique sukuk structure.

The increasing sophistication of financing tools that deliver similar results through commodity murabaha or murabaha backed by wakala certificates or sukuk will improve the functioning of the Islamic interbank markets. These markets are unlikely to disappear in the coming years. Therefore, the industry will benefit by supporting these efforts, which increase the authenticity of the structures used by linking them more directly to tangible assets in the local economy.

**10.** NASDAQ Dubai. "Nasdaq Dubai Murabaha Platform," <http://www.nasdaqdubai.com/solutions/nasdaq-dubai-murabaha-platform>. Accessed September 7, 2016.

**11.** Staff report. "Emirates Islamic completes Murabaha on Nasdaq Dubai," *Gulf News*, May 15, 2016. <http://gulfnnews.com/business/sectors/markets/emirates-islamic-completes-murabaha-on-nasdaq-dubai-1.1828210>

## CHAPTER 5

# The NBC Sukuk Trading Platform





# The NBC Sukuk Trading Platform

## National Bonds Sukuk Savings Product

*A unique savings product that supports infrastructure development in the UAE*

Beginning in 2006, National Bonds Corporation PJSC created a mudaraba investment fund called National Bonds Mudaraba to act as a savings vehicle for the retail market in the UAE. Since its launch, it has grown significantly, reaching over AED 5.8 billion (\$1.55 billion) under management with 900,000 customers representing 200 different nationalities. The National Bonds sukuk is a unique retail product that offers higher yields than most bank deposits, while allowing small savers to participate. Each bond has a face value of AED 10 (\$2.72).

The structure of the savings product involves funds being contributed to the mudaraba where each bond provides ownership over the pro rata share of the assets and distributable profits of the mudaraba. Funds collected in the savings program are invested across infrastructure projects, for at least 60% of total assets, and other Shariah compliant assets including liquid assets, shares and sukuk.

National Bonds are designed to deliver an expected 3% annual return to National Bonds sukuk holders. In addition to cash returns, savers are eligible to participate in prize drawings, for rewards such as cash and vehicles. To ensure Shariah compliance, these prizes are paid from the National Bonds' shareholder's own funds. The prize structure is designed in a way that encourages regular saving, to build a savings culture in Dubai.

The proceeds of the sukuk support investment in infrastructure, including public utility, medical, educational and housing assets. This establishes National Bonds' link to the real, non-financial, economy in a way that is clearer than other types of financing products, for which the link to the real economy is more indirect. The connection between the returns on the underlying assets and the returns paid to savers is also more direct. Savers receive actual returns available for distribution, not a return linked to the prevailing interest rates, as with bank deposits.

## NBC SUKUK TRADING PLATFORM PARTNERS



## National Bonds Trading Platform

### *Expanding the use of infrastructure-backed sukuk provide a novel financing product to banks*

In addition to the development of the sukuk as a unique savings scheme for UAE nationals and expatriates, National Bonds Corporation offers a trading platform that allows the sukuk creation and redemption process to create financing products for banks. The Sukuk Trading Platform offers a new solution that fits seamlessly into the existing process flow but with lower costs and better audit tracking. Operationally, the platform can be customized to fit the requirements of each institution at all levels.

As shown in the diagram below, an individual or corporate client needing financing approaches local banks and is processed using the regular screening process for receiving financing. This allows the banks to use their existing front-end processes. If the customers are approved for financing, the bank will make payment to National Bonds to purchase sukuk equivalent to the value of financing the customer requests. The bank then sells this sukuk to the customer in a murabaha transaction, in which cost and profit are specified and fixed. The customer is provided the opportunity to make deferred repayment across a fixed period of time. This provides a transaction outcome for customers that mirrors what they would get from a loan or other type of Islamic financing product.

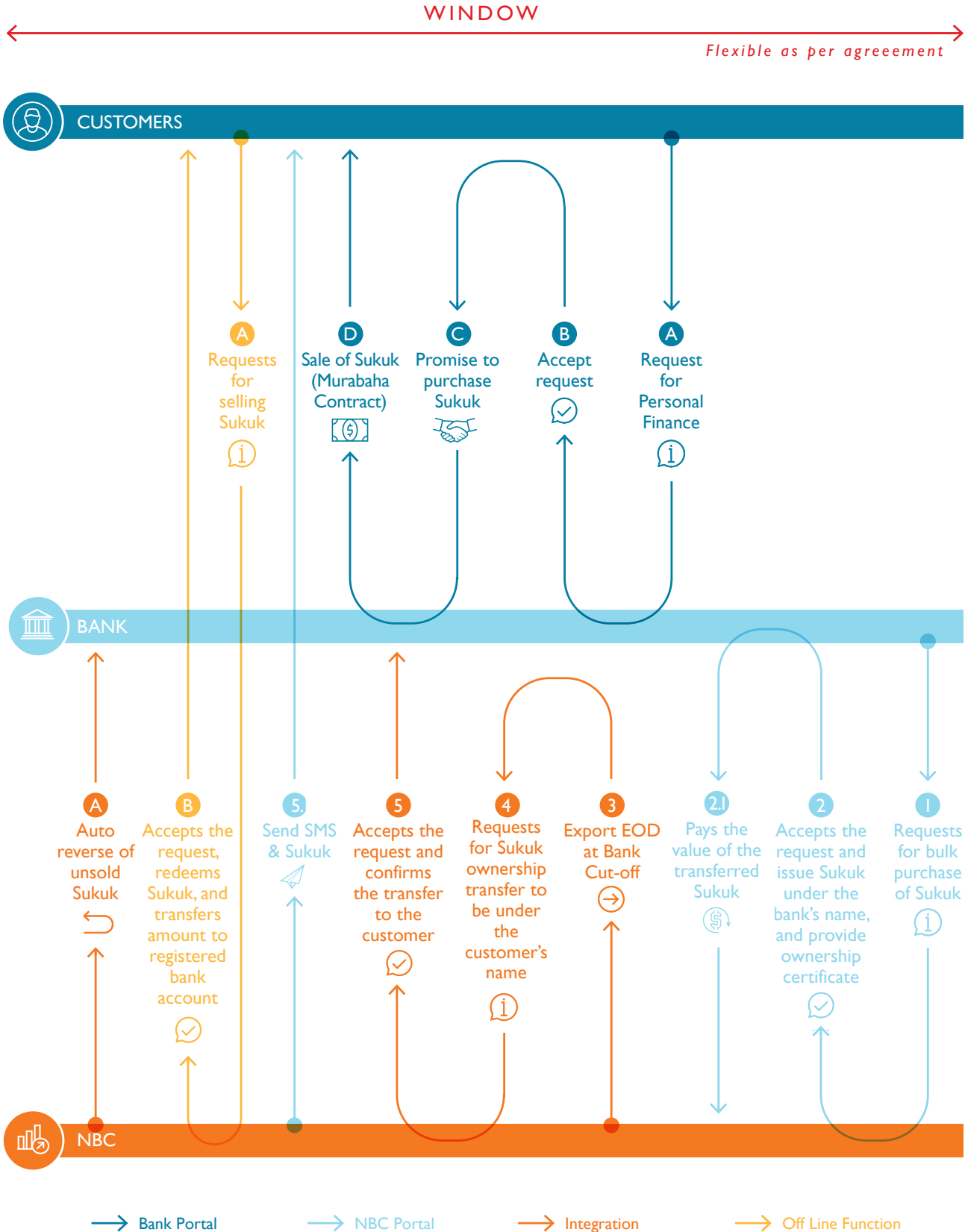
In one of the main differences from regular bank lending, clients will have transferred to them specifically identifiable sukuk, with unique serial numbers, which provides them validation that

the structure of the transaction involves the real transfer of assets. In addition, the structure is different from other murabaha-based solutions because it avoids 'binding agency' in its contracts, where the customer appoints the bank as his agent to liquidate the asset on which the murabaha is based. This has attracted significant criticism on Shariah grounds. In lieu of 'binding agency,' customers receive delivery of the National Bonds sukuk directly and deal directly with National Bonds, and not the bank, when they redeem their sukuk.

Once the customer receives the National Bonds sukuk, they are able to choose whether to redeem them immediately with National Bonds for cash or hold some or all of them depending on their need for the cash. If, for example, the client seeks financing for an immediate purchase such as an automobile, he or she would redeem the National Bonds immediately. If there were a need for only partial use of the funds immediately, then the customer has the option to keep and earn profits on some or all of the sukuk they acquired from the bank once their initial holding period exceeds 30 days.

When the customer holding National Bonds sukuk elects to liquidate their holdings, they make a request directly to National Bonds to redeem their sukuk, and National Bonds transfers the redemption value to the customer's account. They may also transfer the right to the redemption amounts to their creditors, if the financing were used to refinance existing financing arrangements, creating additional flexibility for the customer.

CROSS-FUNCTIONAL BUSINESS PROCESS



## Advantages

### *Avoid Cost — Cost effective, Highly Flexible and as per true Shariah guidelines for alternate products*

The process used on the trading platform has several distinct advantages over the current method of Islamic bank financing, and it should also provide a wider benefit to the economy relative to conventional financing. The murabaha process remains simple for the customer because they complete the paperwork with the bank for the financing and then receive (and redeem, if they choose) the National Bonds sukuk electronically.

The murabaha with sukuk offers a simplification of the process for the bank and expanded flexibility for customers and a more authentically Shariah-compliant structure for both. This contrasts with the structure of a commodity murabaha transaction, where the underlying commodity is owned only in passing and for all intents is never a useful or potentially profitable object for either party to the transaction. Moreover, for common murabaha transactions using other assets, including equity shares, customers have a more limited right to take delivery and to hold or dispose of these assets.

National Bonds' Sukuk Trading Platform has operational advantages in addition to its greater Shariah authenticity. The platform has fewer fees than in commodity murabaha because the bank pays a flat fee to National Bonds but there are no brokerage fees as there would be in commodity murabaha. The bank is also able to buy and hold the underlying asset for a limited period to allow faster execution. Furthermore,

when the transactions between the bank and the customer occur, there is no spread between the price paid to subscribe to the sukuk and the price received when redeeming the sukuk. Other murabaha transactions, even those that have nearly instantaneous execution, require brokers and involve spreads between the bid and ask prices.

The advantages are innate to the development of the National Bonds sukuk product because it offers a traceable and verifiable transfer of ownership of a tangible asset from bank to the customer, who may choose whether to redeem it with National Bonds. This avoids with the Shariah objections to commodity murabaha products. In addition, it has the flexibility to serve both personal financing needs and interbank liquidity management needs which is lacking from products such as wakalah, which cannot be used for personal finance transactions.

Finally, the National Bonds' Sukuk Trading Platform provides an auditable system from end-to-end for Shariah boards to verify compliance with the approved structure. From the start of the process, when the bank gets an allocation of sukuk that it can sell in financing transactions, through the approval of the customer's financing and the bank payment to National Bonds, to the end, when the bank requests that the sukuk be transferred to the customer and titled in their name, full data are collected that allow for a comprehensive audit that ensures the process satisfies the fatwa Shariah boards is followed.



# ABU DHABI ISLAMIC BANK

**Hassan Owais Kazmi**  
Head of Asset, Abu Dhabi Islamic Bank



1. What are the most common structures you use for providing personal financing for retail customers?

We use the following Shariah-compliant structures for our personal finance customers:

- a. **Tadawul (share financing):** under this structure the customer enters into a murabaha agreement with ADIB to purchase Shariah-compliant shares listed in ADX and DFM. After the purchase, the customer then has the right to sell the shares to generate liquidity or to hold them for investment purposes.
- b. **Sukuk finance:** ADIB participates in the NBC mudarabah pool by investing in NBC Sukuk. Under this structure, the customer enters into a murabaha agreement with ADIB and in turn ADIB transfers its Sukuk holdings to the customer. After the transfer of the Sukuk to the customer, he has the right to redeem the Sukuk to generate liquidity or to hold it for investment purposes.
- c. **Al Khair Liabilities settlement:** ADIB buys LME commodities in bulk and sells it to its customers on a murabaha basis. This variant is used for the settlement of liabilities of the customer from conventional banks only.

2. What are the different challenges you face when you structure personal financing for tangible assets such as homes or automobiles, on the one hand, or unsecured personal financing, on the other? Do the existing products meet all your needs?

All products offered by ADIB are structured specifically to meet the requirements of our customers.

As an Islamic Bank, whenever a customer applies for finance from us, it must be backed by an underlying asset sale transaction whereby the selling price of the asset is agreed at the outset and does not change. We at ADIB offer the option of using National Bonds or listed shares in DFM or ADX as the underlying asset for completion of the Murabaha transaction.

The very structure of Shariah compliant financing gives a significant edge to the Islamic banks from a transparency and fairness perspective.

3. Have you used the National Bonds Sukuk Trading Platform?

We have been using the NBC Trading platform for over a year now and find it very efficient and easy to use. It helps us in meeting the personal finance needs of our customers.





# MINHAJ ADVISORY

**Dr. Amin Fateh**

General Manager, Minhaj Advisory



منهاج للاستشارات  
MINHAJ ADVISORY

1. The dearth of Islamic liquidity management instruments has been a challenge in Islamic banking throughout its 40-year growth and maturity. In your opinion, what are the key obstacles facing Islamic liquidity management today?

The modern banking industry started in the seventeenth century and has gone through many evolution phases, while Islamic banking only started 40 years ago, and it has already taken over a considerable share of the market. The Islamic Banking started where other have ended, accepted those that are compliant with Shari'ah and modified the other approaches to be Shari'ah compliant. Based on this, Islamic liquidity management instruments are still their infancy, and the main challenge (not obstacle) is how provide liquidity management tools that compete with conventional ones. Therefore, Islamic financial institutions should invest more and more in product development.

2. In your opinion, what are the key Shariah issues with commodity murabaha as a product? What are the alternatives available in the market?

In principle, commodity murabahah is not a mode of investment or financing. It has been permitted by Shari'ah scholars when there is a need for liquidity, subject to specific terms and conditions. The main issue that scholars highlight in commodity murabahah is to distinguish it from "bay' al-'inah".

Obviously, murabahah, investment agency and other Shari'ah compliant modes are the alternative. In the absence of assets with different

alternatives in the market, Sukuk trading by NBC, where the Sukuk represents different assets when purchased from the ones at the time of sale, will be one of the best alternatives.

3. What are the different challenges faced in structuring personal financing products, especially where there are no tangible assets? Do the existing products meet the needs of customers or the Islamic banks?

To clarify, the trading of tangible and non-tangible assets is permitted by Shari'ah scholars (although cash and receivables are not permitted, except for the same value and on spot).

4. Do you think that Sukuk Trading Platforms can be an alternative solution for liquidity management? What are STP's advantages compared to other approaches?

- Online
- Multiple currencies (local currency)
- Option for customers to redeem immediately or keep the Sukuk

5. Are there any changes that would make the Sukuk Trading Platform a more preferred platform for most banks either for liquidity management or for personal financing?

It would be better to have the option of buying Sukuk through murabahah for saving purposes rather than limiting the platform to be for liquidity management.

A modern living room with large windows and a person holding a tablet. The room is bright and airy, with a blue sofa in the foreground and a person's hand holding a tablet on the right side. The background shows a view of trees and a building through the windows.

CHAPTER 6

The NBC  
Proposition



## The NBC Proposition

In building a culture of saving and investment, it is crucial for banks to provide retail savers with easy-to-use products that both generate returns and are relatively secure. Even in mature Islamic finance markets, there is a limited range of such options that are Shariah compliant, which makes National Bonds' sukuk trading platform a valuable proposition beyond the borders of the UAE and across the GCC. Outside even this core market, NBC's innovation proves it is possible to develop a scalable solution using Islamic finance to harness local savings in infrastructure improvements to deliver society-improving benefits.

The growth of National Bonds from its inception in 2006 until today has been impressive, with more than 900,000 savers and total assets of AED 5.8 billion (US\$1.55 billion).

National Bonds' expansion into personal financing with its Sukuk Trading Platform has opened up new avenues for Islamic banks in the UAE to offer financing that meets custom-

er demands. The platform provides a rigorous process by which Islamic banks can use the tangible underlying assets of mudaraba sukuk to structure personal loans in a more efficient way than commodity murabaha that both facilitates post-transaction Shariah audits and avoids Shariah conflicts.

### *Possible Product Offerings from a Sukuk Trading Platform*

The financing activities linked with a sukuk trading platform include, but are not limited to, the following:

1. Provide a Shariah-compliant structure for retail and corporate financing at Islamic banks and other financial institutions.
2. Help Islamic banks and other financial companies to manage liquidity through placement.
3. Support for offering Shariah-compliant fund placements between commercial banks and the central banks.

## Benefits

National Bonds provides its customers with the benefits of a safe, Shariah-compliant savings product that opens the sukuk to the retail market in a way not widely available previously. Savers are able to invest regularly and have access to liquidity when they need it. As investors, they are offered a competitive return and the opportunity to participate in prize drawings, while aware that their savings are being used to support infrastructure development in the UAE.

The benefits to the customer are enhanced by the clear structure of the mudaraba contract, which avoids the Shariah issues associated with other structures. Simply put, National Bonds invests retail savers' funds directly into infrastructure assets that generate the necessary

return while maintaining an appropriate risk level. The consumer—who receives an individual certificate electronically—owns a proportional share of the mudaraba assets and receives a fixed percentage of the profit from the underlying assets.

The profit share attributable to the retail saver in his role as *rabb al-mal* is used to fund his returns, while the profit share attributable to National Bonds Corporation as *mudarib* is used in part to fund the prize drawings. This is not only a more simple structure than other sukuk, it provides a more direct connection between the saver's invested money and the projects it funds than even an Islamic bank, without sacrificing the consumers' liquidity.

## Transition to NBC – Sukuk Trading Platform

NBC has leveraged its success with the sukuk savings program to establish its Sukuk Trading Platform, which allows Islamic banks to offer Shariah-compliant personal financing. The trading platform provides an underlying asset to the banks which they can pre-buy in bulk with the ability to return to National Bonds any sukuk that remain unused in its

financing activities with no spread relative to the purchase price (AED 10 per sukuk). The trading platform, as a separate entity from the bank, also offers a solution to a difficult problem related to commodity murabaha whereby the coordination of the different legs of the transaction raises significant Shariah complications.

## Impact on efforts to position Dubai as capital of the Islamic economy

The National Bonds Sukuk Trading Platform supports Dubai's effort to establish itself as the capital of the Islamic economy by connecting the retail market to infrastructure financing with a Shariah-compliant savings product. This unique structure, which provides returns on a profit-sharing model in close accordance to the preference of many Islamic finance consumers, sets a precedent for the region and the rest of the world, where Islamic retail savings products are not as well developed as financing for large companies.

This is particularly important in emerging markets, because mobilizing savings for infrastructure investments is key to maintaining and raising the rate of economic growth. Such products are also essential for supporting the development of a robust private sector that can meet the employment needs of the population and diversify sector development beyond commodity extraction and export. The savings collected through the National Bonds sukuk is directly invested into different types of investments including infrastructure..

The National Bonds Sukuk Trading Platform provides a systemic economic advantage over commodity murabaha. The structure of a commodity murabaha uses Shariah-compliant methods, but uses commodities with little

relevance to the local economy to structure transactions equivalent to interest-based transactions. In many cases, these commodities are traded on global commodity exchanges and are physically located in other countries.

By contrast, the National Bonds assets are tangible, productive assets that generate an economic benefit that provides a real basis for their returns. The returns, although in line with local rate conditions, are variable, and they depend on the underlying economic returns of the assets. Sukuk holders do remain at risk of loss, although the management of the assets are conducted in a way that focuses on capital preservation and income. However, in providing financing to domestic infrastructure assets, they directly support the local economy and its future growth. Moreover, the fact these assets are owned by the Government and Investment Corporation of Dubai provides investors with the strong benefit of financial security.

By demonstrating that Islamic finance can deliver a positive impact on the wider economy, the National Bonds Sukuk Trading Platform expands upon Dubai's existing Islamic economy initiatives. Moreover, by increasing the authenticity of the existing Islamic finance landscape Dubai is setting a new precedent that can be used in other Islamic finance markets.





# Innovation in Islamic Liquidity Management 2017

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