

SOVEREIGN SUKUK A WAY TO REVIVE THE CELTIC TIGER?

Ken Owens, FCA and **Yvonne Thompson, FCA** examine the role sovereign sukuk can play in the future of Ireland's economy.

Amid all the market-volatility of the last few years, Islamic finance has succeeded in outperforming conventional investment methods. Not only has it avoided most banking stocks but, by its nature, it avoids risky derivative products and highly leveraged companies. Instead Islamic finance is based on equitable distribution of wealth, asset-backed financing and the sharing of risks and rewards.

The Islamic finance market is growing at about 15-20% per annum and equity fund assets alone are forecast to jump from US\$15Bn in 2008 to US\$1.6T in 2012. This growth is largely driven off a combination of structural and behavioural changes in Islamic countries, as well as a desire from investors – Muslim and non-Muslim alike – for higher growth rates and

perhaps the greater security or certainty offered by asset-backed finance.

The attractiveness of Islamic financing continues and we now see a number of European countries in particular move to alter their existing laws, regulations and tax frameworks to accommodate this type of finance. Ireland has played its own part in this move towards accommodating Islamic finance transactions with the specific adaptation of its tax legislation in 2010 and recent supportive changes in 2011. There has been little activity in this area in Ireland since the tax changes but could Islamic finance deliver a catalyst to stimulate the Irish economy? This article considers the use of a particular Islamic finance product, sukuk, as a means of delivering sovereign financing and how that might position Ireland's financial services industry for further growth.

investor, the return would instead be generated from the state-owned assets 'backing' the sukuk.

The first sovereign sukuk was issued by Malaysia in 1983 but it was the subsequent success of the conventional securitisation markets that delivered the real boom in sukuk issuances evident from the early part of this century. The use of sovereign sukuk has grown significantly over the last decade, but particularly over the last two years as many countries, across Europe and beyond, have altered their regulatory and tax regimes to accommodate their issuance. Indeed, over US\$20Bn of sovereign sukuk were issued in 2010.

HOW DO SUKUK WORK?

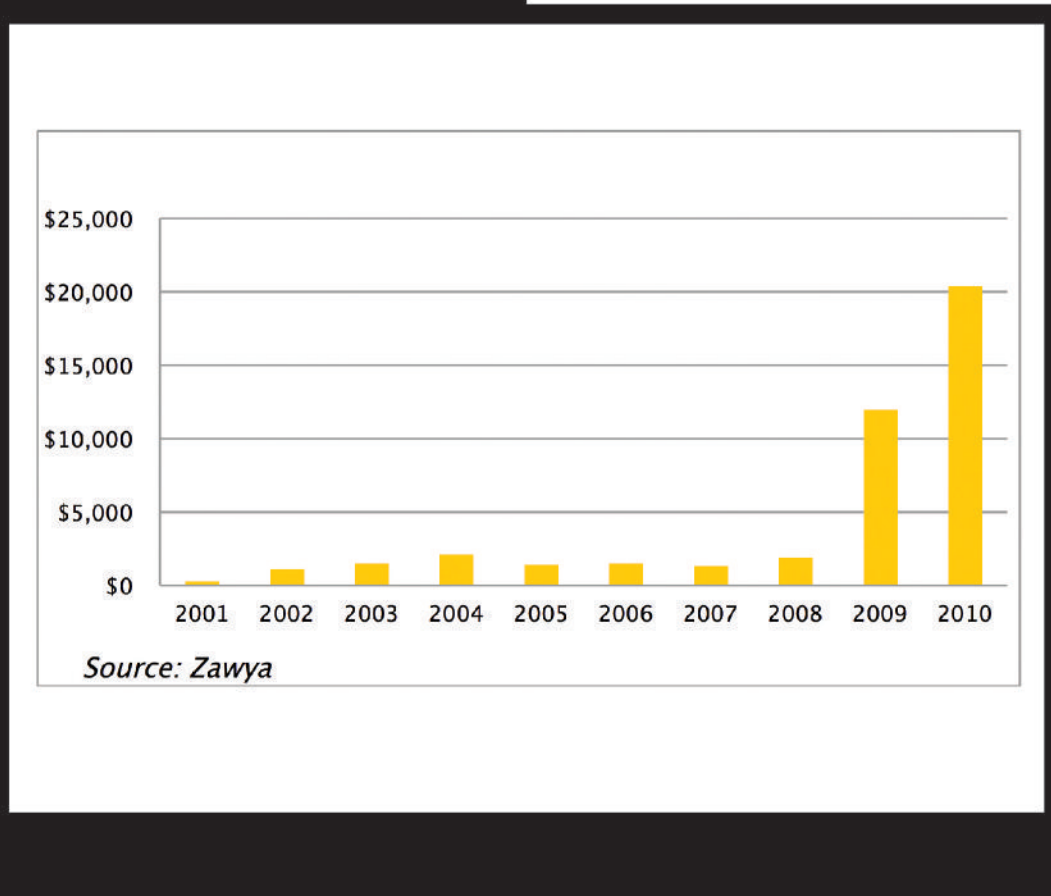
When combined with other Islamic finance arrangements, such as an ijarah

WHAT ARE SUKUK?

Sukuk are Shariah (Islamic law) compliant financial instruments, essentially certificates which in economic terms are akin to bonds. Sukuk vest partial ownership of underlying assets (e.g. machinery, property, etc.) in an investor, providing a return based on the net profits generated from those assets. The value payable on maturity is the market value of the underlying assets at that time. A sovereign sukuk would involve a country essentially borrowing (in conventional terms) from the capital markets but rather than the borrowing delivering an interest return to that market



Figure 1
Sovereign sukuk issuance 2001 to 2010



(akin to a conventional leasing arrangement), sukuk can facilitate the Islamic securitisation of assets. Let's look firstly at a sovereign sukuk ijarah.

In figure 2, overleaf, we assume that a sovereign state (Country A) sells certain assets to a special purpose vehicle (SPV) which pays for the assets using proceeds raised through the issuance of sukuk to investors. The SPV holds the title to the assets on trust for the investors and leases the assets back to the state for a fixed period of time. During the life of the sovereign sukuk, Country A makes regular rental payments to the SPV in return for the lease of the assets. The SPV, in turn, pays a periodic distribution to the investors based on the amount of rental payments received from the state. On maturity, Country A has the right to acquire the assets back from the SPV or, depending on the terms of the investment, to substitute the underlying assets with other assets.

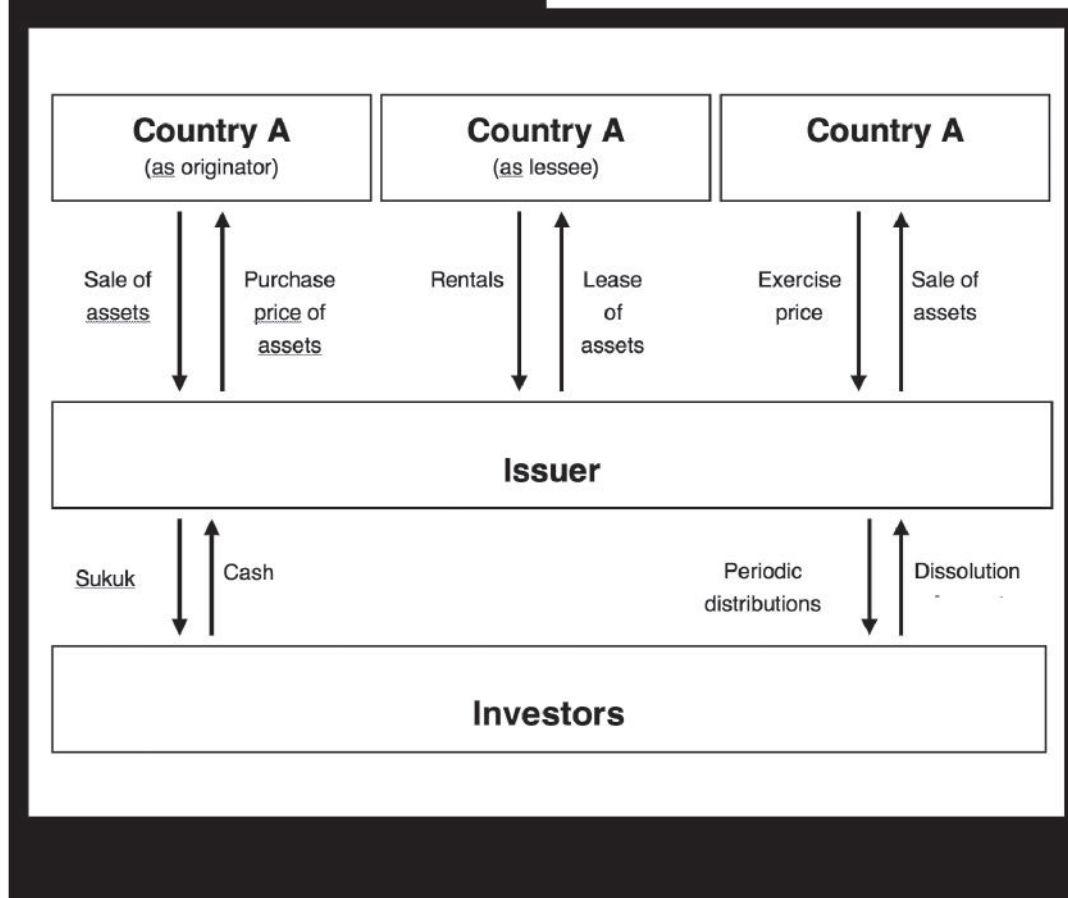
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COULD A SOVEREIGN SUKUK HELP IRELAND'S FISCAL POSITION IN THE FUTURE?

There are potentially a number of reasons why a sovereign sukuk could be an attractive proposition for Ireland Inc. in the future:

- ▶ There are many examples of countries using sovereign sukuk to raise finance. In 2005, Pakistan raised €457M backed by national assets including the 400-kilometre Islamabad-Lahore Motorway. In January 2011, two state-owned companies in Malaysia raised €931M using sovereign sukuk and Saudi Arabia has recently announced plans to raise €900M to part finance a new terminal at Jeddah airport.
- ▶ Ireland has recently agreed a €67.5Bn funding facility with the European Union (EU) and the International Monetary Fund (IMF) at an annual interest rate of c.5.8% and this will likely keep Ireland out of the debt markets for some time to come.

Figure 2
Flow of funds and assets in a sovereign sukuk



However, when Ireland re-enters the market, the option of a sovereign sukuk may provide access to an alternative source of finance. It would take Ireland's commitment to building relationships and strengthening ties with the resource-rich, Middle East countries to the next level while at the same time offering us a substitute for existing international lenders.

In addition to access to finance, sovereign sukuk offer other advantages to the issuing country. Firstly, as their value and yield is derived from the performance of the underlying assets, it means that the cost of this finance does not fluctuate due to changes in the financial conditions of the sovereign. Secondly, as the finance raised is essentially the equivalent of private sector funding, it provides the issuing state with greater flexibility to make economic decisions without the external political influence or conditions that may come with other forms of state-backed finance.

► Ireland now has a supportive tax framework. The tax legislation introduced in 2010 means that tax treatment of sovereign sukuk is similar to a conventional bond while changes to Ireland's securitisation offering in 2011 should enhance the ability to accommodate certain Islamic finance transactions. Ireland has also entered into double tax agreements with 62 countries including Bahrain, Kuwait, Turkey and UAE (a treaty with Saudi Arabia is imminent).

...AND PLAY A PART IN IRELAND'S ECONOMIC RECOVERY?

In addition to the contribution which sovereign sukuk could potentially make to Ireland's fiscal position in the future, Islamic finance could also play a part in renewing growth in Ireland's investment management and securitisation industries. Importantly, the issue of a sovereign sukuk would raise Ireland's profile in the international financial

markets and demonstrate Ireland's commitment to the Islamic finance world, while also potentially giving us first-mover advantage in this space in Europe in particular.

Sovereign sukuk have attracted a wide variety of investors in the past and the issuance of sovereign sukuk globally has grown substantially over the past decade. Despite the global financial crisis in 2009, the Government of UAE successfully issued a €1.4 billion sukuk. It received a positive response from the market, which renewed investor confidence in the UAE and helped lift doubts about its ability to meet its debt obligations. Could a sovereign sukuk issue by Ireland, together with the spin-off additional Islamic finance activity in Ireland, provide that type of boost to the Irish economy in the future? It seems to be definitely worth considering. ■

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