Planning for capital

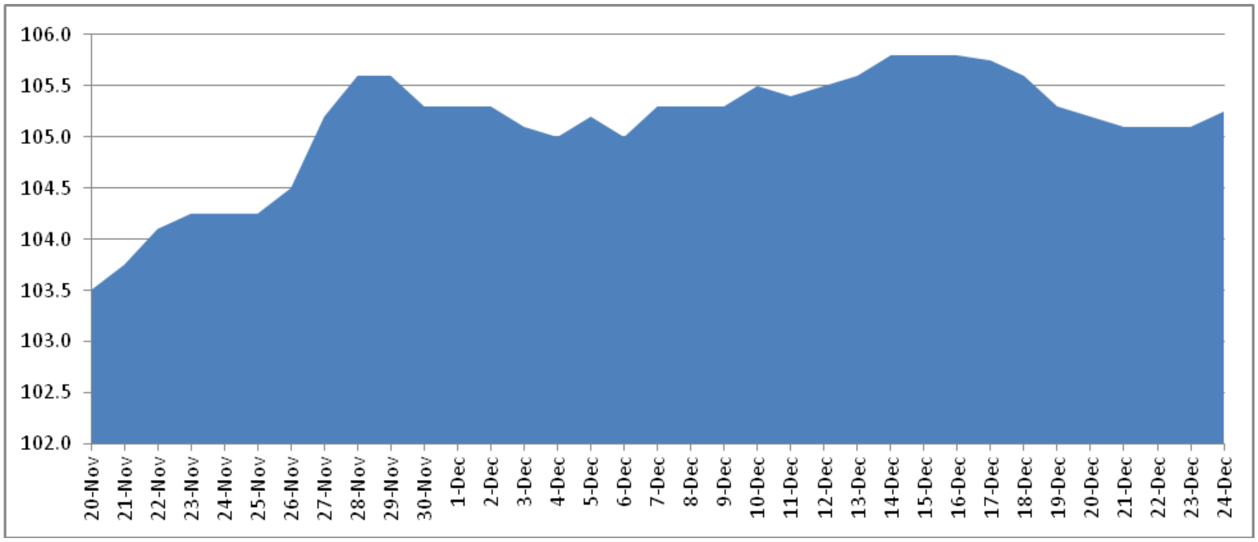
By Nida Raza

Abu Dhabi Islamic Bank ("ADIB") recently became the first financial institution in the world to issue a hybrid Sukuk which qualifies as Tier I capital per Basel III guidelines. The bank raised $1bn after a successful roadshow which saw order books of over $15bn for this credit and over 330 investors globally placing orders. ADIB's $1bn Tier I Sukuk is a deeply subordinated perpetual security with a first call in 6 years, and carries a coupon of 6.375%. This security's profit rate resets at year 6, at a rate of 6-year swap rate plus the initial margin. The security will be first callable after year 6, and then semi-annually thereafter with 60-days notice falling on every profit payment date.

As Islamic banks in Malaysia look to grow their balance sheets, capital management will become paramount as competition increases and margins squeeze. A key priority for 2013 would be lowering cost of capital to defend market share and compete effectively against larger conventional peers, many of whom are already ahead with non-equity Tier I transactions in the capital markets. The time for Islamic banks to take action is now, through prudent capital planning and optimization, while liquidity is present in this part of the capital structure.

ADIB's senior credit ratings are A2/NR/A+. This subordinated capital security was unrated. One would expect a 2-3 notch lower rating if this paper were to be rated due to the deep subordination in capital structure. From an Islamic structuring perspective, this type of security most closely matches the substance over form issues and criticisms that the industry has faced over the last few years. It has equal profit and loss-sharing features, and per certain restrictions and conditions, depending on the Bank's profitability, it allows non-payment of profits. What is more, there is no accrual feature, which most resembles a true equitable relationship. This security is senior only to common equity in ranking and payments. Since the release of Basel II guidelines in 2002 which allowed "innovative Tier I" issuance as part of total Tier I issuance, the banks in the developed countries in Europe, US and Asia have all raised many billions of US Dollars to shore up their core capital requirements. However, the Gulf region had remained conservative, mainly due to no guidelines being provided by central banks. Central banks took the stance that since there is no demand from their banks to issue these guidelines, they will remain mute till approached. All this changed in 2008/9 when demand from banks allowed central banks to publish rules on Innovative Tier I capital, and in line with Basel II/III, it is limited to 15% of the original core Tier I capital. With the new enhanced core equity rules, innovative Tier I issuance limit is smaller, but nevertheless, still a cheaper option to common equity, as well as not being dilutive to shareholders.

The transaction was driven by a broad demand across three regions, with allocations of 38% to Asia, 32% to the Middle East, 26% to Europe, and 4% to US offshore investors. By investor type, 60% of the Sukuk was sold to private banks; asset and fund managers bought 26%, commercial banks 11% and others 3%. This is a typical investor trend for this type of subordinated paper issued by a high quality quasi-governmental credit institution. Private banks are always looking for enhanced yield on high quality paper and this structure suits them best.



Source: Zawya/ ThomsonReuters

The above graph shows the continuous demand for this credit in the secondary market where the paper trades at a premium of 105.2%, which roughly equates to a yield of 6.00%. To put this in context, ADIB's dividend yield on their equity is 7.4% and their senior Sukuk was priced last November at a coupon of 3.78%. It is currently trading at 105.2%, approximately yielding 2.40%. Retail investors, life and other insurance companies lap up these types of structures as their long-term nature with the call option and floating rate reset mechanism suit their liability profile. The search for yield is once again driving many sophisticated institutional and retail investors down the capital structure.

Since this has been a highly successful transaction, we believe this will set a trend for other Islamic and conventional banks globally. Asia has historically, on the conventional banking side, seen volumes of hybrid Tier I issuances, especially out of Malaysia, Korea and the Philippines. Interestingly, the Islamic banks have not followed this trend yet and issued non-equity Tier I transactions similar to their conventional equivalents. This highly successful debut by ADIB and the participation of c.38% of investors from Asia clearly show the understanding and sophistication of the Asian investors as well as their appetite for this type of product. As Malaysian banks look at ways to deepen further the Islamic Sukuk market and evolve into regional institutions, we expect this type of hybrid sukuk to be high on the agenda of all stakeholders, especially as they look for products which appeal to the wider audience of institutional and retail investors.

Let's watch this space in 2013 and see how the anticipated trends unfold.

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