Insights

BASEL III SUKUK INNOVATED

The sukuk sector of Islamic finance has witnessed the emergence of a new growth driver in the form of Basel III compliant sukuk instruments for satisfying Basel III capital adequacy standards. Particularly, the Islamic finance industry had to innovate a new breed of sukuk instruments that have features of loss absorption to satisfy the AT1 and T2 requirements of Basel III.

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Basel III sukuk: A new growth sector in global sukuk markets

Since the gradual implementation of Basel III regulations starting January 2013, Islamic financial institutions have increasingly begun to tap the sukuk market to issue Basel III compliant instruments that satisfy the revised capital adequacy standards. To date, a total of 14 Basel III compliant sukuk have been issued raising USD6.93bln in proceeds for 13 different issuing banks. In 1H2014 alone, 10 Basel III compliant sukuk have been issued in three countries, namely Malaysia, Saudi Arabia and the United Arab Emirates[1].

In addition to the enhanced capital adequacy requirements, the revised Basel III standards also introduce a Liquidity Coverage Ratio (LCR) for short-term liquidity, which mandates banks to hold high-quality liquid assets (HQLA) starting from January 2015. To satisfy the LCR needs, the International Islamic Liquidity Management Corporation (IILM) has issued USD4.54bln[2] worth of highly rated and tradable short term sukuk instruments to date.

Overall, to address the revised capital adequacy standards and satisfy the Basel III LCR, sukuk have proven to be instrumental tools. Moving forward, future Basel III sukuk issuances are likely to enable this sector to emerge as a critical growth driver of the global sukuk market.

Basel III: Revised Capital Adequacy and Liquidity Coverage

The global financial industry is currently in the midst of adopting Basel III regulations, in gradual effect starting from 1st January 2013 and all the way until 1st January 2019. The revised regulations notably have an impact on financial institutions' capitalisation structures as the components of regulatory capital have been reclassified as Tier 1 (T1), consisting of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) instruments, and Tier 2 (T2). The CET1 instruments consist of ordinary shares and reserves while AT1 capital is a layer of additional going-concern capital which is perpetual in nature. Tier 3 capital has been abolished under Basel III. The redefined criteria for qualifying regulatory capital has also impacted the forms of capital instruments that will be suitable to be issued as T1, AT1 and T2. Under Basel III, T1 capital instruments will absorb losses under a going concern scenario while the T2 instruments will absorb further losses when the bank reaches the point of non-viability or gone concern.

Basel III also mandates the minimum capital requirements expressed in risk-weighted assets to be stepped during the transitional period between 2013 and 2019, up to:

[1] ibid
[2] ibid

- 4.5% in share capital (CET1);
- 6% in total Tier-1 capital (4.5% CET1 + 1.5% AT1); and
- 8% total capital (6% total Tier-1 capital + 2% Tier-2 capital).
- In addition, a conservation buffer is required to be built up to a percentage of 2.5% starting from 1st January 2016 and through to 1st January 2019.

Ultimately, banks are required to hold 10.5% of their total capital expressed in risk-weighted assets by 1st of January 2019. The period between 2013 and 2019 is the transitional period and in this period, the applicable capital requirements are highlighted in the table below:

Basel III phase-in arrangements
(All dates are as of January)

	Phases	2013	2014	2015	2016	2017	2018	2019
	Leverage Ratio	Parallel run 1 Jan 2013 - 1 Jan 2017. Disclousre starts 1 Jan 2015					Migrate to Pillar 1	**9.0**
Capital	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	**4.5%**
Capital	Capital Conservation Buffer				0.625%	1.25%	1.875%	**2.5%**
Capital	Minimum Common Equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	**7.0%**
Capital	Phase-in of Deduction from CET1*		20%	40%	60%	80%	100%	**100%**
Capital	Minimum Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	**6.0%**
Capital	Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	**8.0%**
Capital	Minimum Total Capital plus conservation buffer	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	**10.5%**
Capital	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	Phased out over 10 year horizon beginning 2013						

Source: Bank of International Settlements

Meanwhile, Basel III also sets a Liquidity Coverage Ratio (LCR) for short-term liquidity, which mandates banks to hold high-quality liquid assets (HQLA) starting from January 2015. The LCR intends to promote short term resilience to potential liquidity disruptions by ensuring there is sufficient stock of highly liquid assets to cover 30-day stress scenario of cash outflows. The LCR requires a bank to hold a stock of unencumbered HQLA to cover the total net cash outflows that can be converted into cash at little or no loss of value in private markets, to meet its liquidity needs for a 30 calendar day liquidity stress scenario[3].

$$\text{LCR} = \frac{\text{Stock of HQLA}}{\text{Total net cash outflows over the next 30 calendar days}} > 100\%$$

Liquid assets usually consist of assets maturing within one year (preferably on a remaining maturity basis), held either in cash or near-cash equivalents – that is, readily convertible into cash with little or no loss of value. The LCR will be introduced on 1 January 2015 with a minimum requirement of 60% and will be gradually increased in equal annual quantum to reach 100% on 1 January 2019.

Sukuk to satisfy revised Basel III Capital Adequacy Standards

Islamic banks, being integrated in the global financial system, are also required to adhere to the Basel III regulations as set by the respective national regulatory bodies. In this process, the sukuk sector of Islamic finance has witnessed the emergence of a new growth driver in the form of Basel III compliant sukuk instruments for satisfying Basel III capital adequacy standards. Particularly, the Islamic finance industry had to innovate a new breed of sukuk instruments that have features of loss absorption to satisfy the AT1 and T2 requirements of Basel III.

> "As the Basel III standards come into effect gradually, a total of 14 Basel III compliant capital adequacy sukuk have been issued to date raising USD6.93bln in proceeds for 13 different issuing banks"

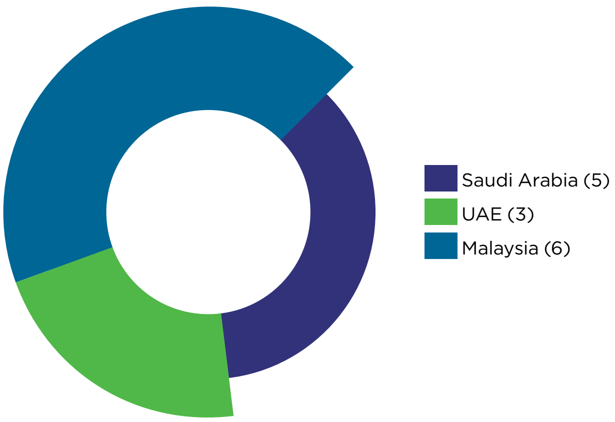
Basel III allows 1.5% of the minimum Tier 1 capital ratio to be in the form of AT1 capital. An AT1 capital instrument is potentially a financial instrument that is structured as a hybrid of equity and debt, offering fixed rates of return to investors while being able to absorb losses under a going concern scenario. Shariah-compliant financial engineering and innovative product development enabled the issuance of the world's first Basel III compliant sukuk in November 2012 which was classified as Basel III AT1 compliant capital instrument. Subsequently, the world's first Basel III T2 compliant instrument was issued in December 2013.

As the Basel III standards come into effect gradually, a total of 14 Basel III compliant capital adequacy sukuk have been issued to date raising USD6.93bln in proceeds for 13 different issuing banks[4].By domicile, Malaysia leads in terms of number of Basel III sukuk issued. Malaysian Islamic banks have collectively issued six Basel III compliant sukuk to date, followed by Saudi Arabia's five and the United Arab Emirates three Basel III sukuk. In terms of issuance volume, Saudi Arabia accounts for 59% of the total Basel III sukuk issued; UAE 36% and Malaysian Islamic banks, account for the remaining 14%.

[3] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013
[4] KFH Research Limited

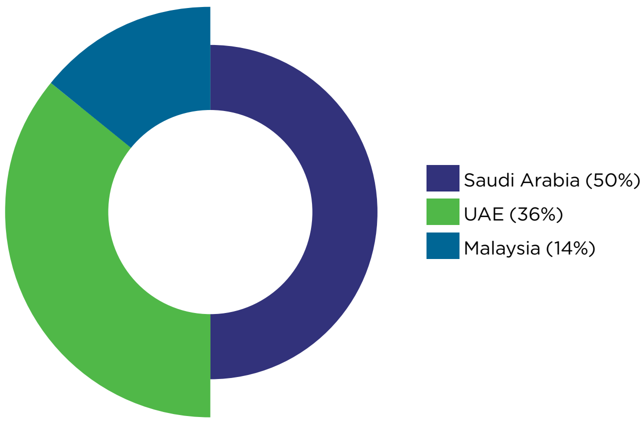
Basel III Sukuk Issuances by Domicile By Number of Issuances

Source: KFH Research Limited



Basel III Sukuk Issuances by Domicile By Volume of Issuances

Source: KFH Research Limited

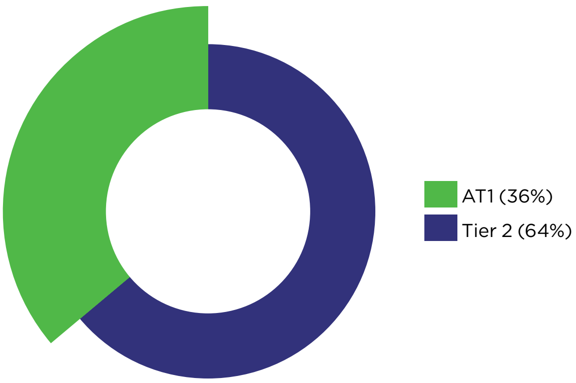


Basel III sukuk have been issued by Islamic banks to meet both AT1 and T2 capital requirements. To date, by type of capital instrument, 64% of the volume raised has supported Basel III Tier 2 capital requirements while 36% has supported the Additional Tier 1 capital[5]. Currently all AT1 sukuk have been issued in the United Arab Emirates while Malaysian and Saudi Arabian banks have issued T2 compliant sukuk.

In issuing Basel III compliant sukuk instruments, Islamic banks have utilised a number of Shariah-compliant contracts.55% of the Basel III sukuk volume raised has utilised the Mudarabah contract while 31% of the instruments have been structured as Hybrids/Combinations. On the other hand, Basel III sukuk structured on the Murabahah contract account for 12% of the volume while Ijarah the remaining 2%.

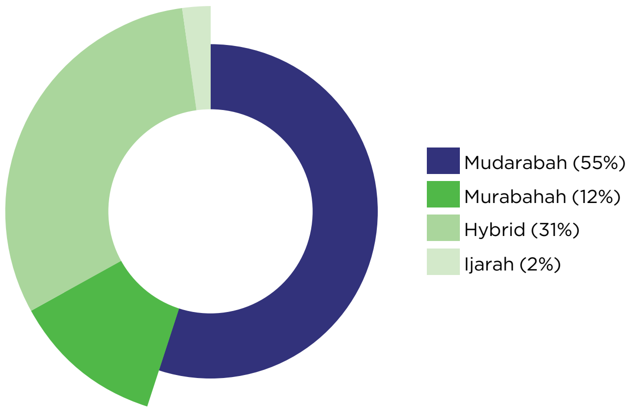
Basel III Sukuk Issuances by Capital Type

Source: KFH Research Limited



Basel III Sukuk Issuances by Structure

Source: KFH Research Limited



[5] KFH Research Sukuk Database

Overall, Basel III compliant sukuk are a pivotal innovation in the global Islamic finance industry enabling Islamic banks to keep abreast with regulatory progresses made in the conventional finance ecosystem. Moving forward, more Islamic banks globally are expected to issue Basel III compliant capital adequacy sukuk to meet their respective national regulatory requirements.

Snapshots on Basel III Compliant Sukuks Issued (to-date)

Sukuk	Structure	Country	Issue Date	Tenure (Years)	Size	Type of Capital
ADIB Capital Invest 1 Ltd	Mudarabah	United Arab Emirates	19th Nov 2012	Perpetual (Callable 5-Years)	USD1bln	AT1
DIB Tier 1 Sukuk Ltd	Mudarabah	United Arab Emirates	20th Mar 2013	Perpetual (Callable 6-Years)	USD1bln	AT1
SHB Tier 2 Sukuk	Combination	Saudi Arabia	15th Dec 2013	10 years (Callable 5-years)	SAR2.5bln	T2
SABB Tier 2 Sukuk	Combination	Saudi Arabia	17th Dec 2013	7 years (Callable 5-years)	SAR1.5bln	T2
NCB Tier 2 Sukuk	Mudarabah	Saudi Arabia	20th Feb 2014	10 years (Callable 5-years)	SAR5bln	T2
Am Islamic	Murabahah	Malaysia	28th Feb 2014	10 years (Callable 5-years)	MYR200mln	T2
Am Islamic	Murabahah	Malaysia	25th Mar 2014	10 years (Callable 5-years)	MYR150mln	T2
Maybank Islamic	Murabahah	Malaysia	7th Apr 2014	10 years (Callable 5-years)	MYR1.5bln	T2
RHB Islamic	Murabahah	Malaysia	15th May 2014	10 years (Callable 5-years)	MYR500mln	T2
Saudi Investment Bank	Combination	Saudi Arabia	5th June 2014	10 years (Callable 5-years)	SAR2bln	T2
Public Islamic	Murabahah	Malaysia	9th June 2014	10 years (Callable 5-years)	MYR500mln	T2
Hong Leong Islamic	Ijarah	Malaysia	17th June 2014	10 years (Callable 5-years)	MYR400mln	T2
Banque Saudi Fransi	Combination	Saudi Arabia	18th June 2014	10 years (Callable 5-years)	SAR2bln	T2
Al Hilal Bank	Mudarabah	United Arab Emirates	30th June 2014	Perpetual (Callable 5-Years)	USD500mln	AT1

Source: IFIS, Zawya, KFH Research

Sukuk to meet Basel III Liquidity Coverage requirements

The introduction of the LCR by Basel III had posed a challenge for the Islamic finance industry given the absence of highly rated short-term liquid and tradable financial instruments that complied with the principles of Shariah. To address this issue, a group of central banks hailing from three different continents along with the Islamic Development Bank (IDB) joined together to set up the International Islamic Liquidity Management Corporation (IILM), a multilateral entity which regularly issues highly rated short-term sukuk instruments to enhance cross-border liquidity flows, international linkages and financial stability of the of the institutions that offer Islamic financial services (IIFS) . Since its inaugural issuance in August 2013, to date, the IILM has currently issued a total of seven series of sukuk which include issuances and re-issuances, worth a total of USD4.54bln with an outstanding sukuk amounting to USD1.35bln[6].

Snapshot of IILM's Sukuk Issuances To Date

Sukuk*	Issue Date	Tenure (months)	Issue Size (USD mlns)
IILM 11/13 (Matured)	29/8/2013	3	490
IILM 2/14 (Matured)	29/11/2013	3	490
IILM 4/14 (Matured)	23/1/2014	3	860
IILM 5/14 (Matured)	28/2/2014	3	490
IILM 7/14 (Matured)	23/4/2014	3	860
IILM 8/14 (Maturity – 28th Aug)	29/5/2014	3	490
IILM 10/14 (Maturity – 23rd Oct)	23/7/2014	3	860
Maybank Islamic	Murabahah	Malaysia	7th Apr 2014

* Numbers in Sukuk indicate maturity
Source: KFH Research

The IILM has notably served to address liquidity management challenges of Islamic banks which has been one of the most critical challenges faced in the Islamic finance industry. The IILM Sukuk satisfy the requirements of the Basel III LCR, subject to the recognition and acceptance by individual local regulators in various jurisdictions. As a result, the IILM Sukuk are widely sought after as solutions by IIFS. In future, the IILM sukuk are expected to be served as catalysts for more short-term and similar sukuk issuances by other entities.

Basel III Sukuk: A Promising Development in the Global Sukuk Market

Basel III sukuk are now playing an instrumental role in addressing the liquidity and capital adequacy needs of Islamic banks as stipulated by the Basel III accords. As a result, given the implementation of the Basel III standards across global markets, more Islamic banks globally are expected to issue Basel III compliant sukuk which will further fuel the momentum in the global sukuk market.

[6] KFH Research Sukuk Database

BASEL III CAPITAL ADEQUACY STANDARDS SUKUK INNOVATED

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The global primary sukuk market has surged ahead in the first half of 2014 (1H14), outperforming the same period last year by 8.2% as new issuances reached USD66.2bln in 1H14. The share of the financial services sector in these new sukuk issuances has dramatically increased in 1H2014 which is underpinned by the growing trend where Islamic financial institutions have begun to tap the sukuk market.

In conclusion, Basel III sukuk represent a milestone development in Shariah-compliant innovation which enables Islamic financial institutions to progress alongside their conventional counterparts. By following international regulatory standards such as the Basel III regulations, the Islamic financial system has further positioned itself as a reliable alternative to the traditional financial system that conforms to international practices. Collectively, all these developments expand the scope and momentum of the global Islamic finance industry to newer growth trajectories. Moving forward, the responsiveness of the Islamic finance stakeholders with newer and innovative product offerings, coupled with requirements to satisfy the regulatory requirements are likely to lead the push for the rapid expansion of the sukuk sector in global markets.

Global Quarterly Sukuk Issuance Trend (2Q12-2Q14)

Source: KFH Research Limited