Financing Islamic banks in the UAE

While it is now abundantly clear that the Sukuk market has failed to realize the predicted surge in sovereign Sukuk issuances following the drop in the prices of oil in 2014, when it was assumed that oil revenue-dependent GCC countries would rush to the Sukuk market in order to fill shortfalls in their spending budgets, the current Sukuk market still presents a mixed picture. Against the backdrop of the current uncertainty in the Sukuk market, RAHAT HUSSAIN DAR looks at some of the likely drivers, challenges and prospects for UAE Islamic banks looking to issue Sukuk in 2017 and beyond.

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On the one hand, some market commentators point to the near-flat growth in global Sukuk issuances in 2016 (global Sukuk issuances showed an increase of 2.2% to reach US$77.1 billion compared with US$75.1 billion in 2015) and expect the market to remain subdued this year and possibly 2018, not least because of the complexity involved in Sukuk issuance. On the other hand, some stakeholders, such as Standard Chartered Saadiq, take a more upbeat view and believe that Sukuk will, as was the belief in 2014, play a central role in the growth of the Islamic finance industry in the years to come.

Such optimism may be justified in light of Dubai Islamic Bank's blockbuster US$1 billion Sukuk issuance on the 7th February 2017, which was the largest Sukuk issuance globally by a financial institution. Other possible Sukuk issuances by UAE Islamic banks in 2017 include Abu Dhabi Islamic Bank and Sharjah Islamic Bank.

Generally, a UAE Islamic bank will look to issue Sukuk for one of the following reasons.

Recapitalization

Most Islamic banks in the UAE, as in most of the core Islamic finance markets (excluding Malaysia), are either partially or wholly owned by the local governments. In previous years, these banks relied on high levels of sovereign deposits (resulting from the high oil prices) in order to maintain a healthy capital base. The recent drop in oil prices has resulted in significant reductions in sovereign deposits, as the UAE and other governments have drawn on their bank reserves in order to fund shortfalls in government spending. Most market observers, including S&P Global, expect the low oil prices to persist for the coming years, averaging US$45 per barrel in 2017 and US$50 in 2018. This is likely to fuel the appetite for UAE Islamic banks to tap into the Sukuk market.

Customer demand

Economic trends and customer demand for funding (retail and public sector) will also have a bearing on the need to issue Sukuk. Currently, there is high demand for funding from UAE corporate customers (particularly in the tourism and real estate sectors). With the UAE economy expected to expand in the coming years, the demand for lending is also likely to increase. This may also fuel demand for Sukuk issuance by UAE Islamic banks in order to expand bank capital to meet the increased customer demand. However, this is not guaranteed. Furthermore, while the expectation is that the UAE government will look to Islamic banks to fund key infrastructure projects such as EXPO 2020 and the US$3 billion expansion of the Al Maktoum International Airport, a recent decision by the Abu Dhabi government to issue conventional bonds instead of Sukuk (which was seen as too complex to implement in the short funding time frame) has also raised concerns among Sukuk market stakeholders. Similarly, Dubai may also decide to issue its own Sukuk in order to fund its infrastructure projects, rather than seek bank funding.

Regulatory compliance/loss absorption

Decreasing sovereign reserves combined with the continuing demand from corporate customers may trigger the need to issue Tier 1 and Tier 2 Sukuk in order to meet capital liquidity requirements under the Basel III accord. We note that the issuance of Sukuk to meet Basel II and III requirements is now a common feature in many GCC jurisdictions, including the UAE, Saudi Arabia and Qatar.

Conclusion

While 2017 looks to be a challenging year for the Sukuk market, the resurgence of the use of conventional bonds by GCC governments and corporations seems to have galvanized key stakeholders in the Sukuk market to take serious steps to standardize legal documentation and Shariah interpretation (which are seen as the main reasons for the recent increase in bond issuances).

While 2017 is unlikely to be the year that witnesses the resurgence of the Sukuk or Islamic finance industry, if Sukuk market stakeholders can use this opportunity to address the major shortcomings with Sukuk issuances, then commentators may still look back at this year as a pivotal turning point in the Sukuk industry.