Convertible Sukuk for funding social welfare in the modern era

As with other countries in the heavily oil-dependent Gulf region, the UAE has taken active steps in recent years to expand its revenue streams (including the implementation of value-added tax, effective the 1st January 2018). After all, relying on treasury reserves, albeit substantial, to plug spending gaps in the national budget was only going to be a short-term solution to the long-term problem of low oil prices. RAHAT DAR writes.

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While oil revenues have dwindled since 2008 (when crude oil prices reached a high of US$147 per barrel), the UAE still needs to find money to push ahead with key infrastructure projects (including EXPO 2020 and the US$3 billion expansion of Al Maktoum International Airport) and social welfare spending, both of which are taking a heavy toll on the government's budget.

In relation to large infrastructure projects, the UAE continues to rely on bank lending and the capital markets (particularly conventional bonds) to provide the necessary funding. However, these options are not readily available to fund social welfare spending. Unlike project finance, there is no prospect of creating new revenue streams or assets which can be used to service loan or bond coupon payments in years to come.

Furthermore, when it comes to funding social welfare programs in a Muslim country like the UAE, there is a strong desire for such funding to be generated in strict compliance with the principles of Shariah.

It is against this backdrop that some UAE governmental entities (particularly at the emirate level) have started using innovative Islamic financing structures to develop long-term revenue streams for social welfare spending. One example is the recent increase in the issuance of private placement convertible Sukuk (generally issued by, and to, government-owned or affiliated entities), which can be converted into the equity of the issuer (usually a company that is listed on an exchange). These convertible Sukuk are generally issued to special funds which have been established to manage the funding requirements of social welfare program(s). Recent examples of such Sukuk issuances include the private placement of Sharjah Islamic Bank's AED266.81 million (US$72.63 million) convertible Sukuk Wakalah and Sharjah Cement and Investment Development Co's AED55.3 million (US$15.05 million) convertible Sukuk Murabahah, both of which were issued to the Sharjah Social Security Fund (an entity that was established in November 2017 to provide funding to social welfare programs in the Emirate of Sharjah). Both Sukuk were issued in December 2017 and immediately converted into the equity of the issuer.

While there is nothing new about a fund (whether commercial or sovereign) using Sukuk as a stable source of income and counterweight to other more volatile and speculative investments, the fact that convertible Sukuk are being issued by, and to, government-affiliated entities and used to fund social welfare programs (rather than commercial projects) sets them apart from other Sukuk issuances.

These issuances provide the funds with the option to generate stable income either through the Sukuk profit payments or, following the conversion of the Sukuk into the equity of the issuer, dividends. Furthermore, as these Sukuk are generally issued by listed companies, the funds also have the option to sell the conversion shares (depending on the liquidity of the relevant market) and benefit from any premium (above the conversion price).

As for the issuer, apart from the obvious benefit of being able to use the issuance proceeds to finance business operations or a specific project(s) without having to resort to bank funding (which would almost certainly be more costly than the profit payments under the Sukuk), the issuer would, following the conversion of the Sukuk into the equity of the issuer, have greater control on payments to the fund, as it would be in a position to decide when to issue dividends. In the case of issuers that are also financial institutions, the conversion shares will also be counted toward the issuer's Basel III capital adequacy requirements.

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The issuance of convertible Sukuk to fund long-term social welfare programs demonstrates both the creative thinking being applied to government spending in the GCC and the ability to use Islamic finance to create innovative solutions to address key challenges facing economies in the region. Given that most market observers, including S&P Global, expect the low oil prices to persist for the coming years, averaging US$50 in 2018, it seems likely that we will see further developments in the way that governments in the region use Islamic finance structures to fund social welfare spending.