USSBC Economic Brief
Sukuk Market Update

Overview

Saudi Arabia is quickly becoming a leader in the growth of the global sukuk market as the government has pivoted to deficit spending to fund its expenditures and flagship Vision 2030 programs. Sukuk issuances have accelerated in recent years across the Middle East and Asia and have been further fueled by the economic shocks of 2020. Demand for excess liquidity, compounded by the unanticipated shocks of the global pandemic and persistently low oil prices, led Saudi Arabia to surpass its previous sukuk issuances high of SAR119.3 billion ($31.8 billion) set in 2017 with SAR122.6 billion ($32.7 billion) of sukuk issued through Q3 2020.

Globally, sukuk issuances rose 4.4 percent YoY during the first nine months of 2020, reaching SAR508 billion ($136 billion). Malaysia continues to be the leading issuer of sukuk while Saudi Arabia is the second largest market and represents a growing market share. The Kingdom's riyal-denominated sukuk program is still relatively new compared to other established markets, but already represents the third highest currency behind the Malaysia ringgit and the U.S. dollar. While sovereign issuances still represent the majority of sukuk, there is a fast-growing corporate segment that includes Saudi Arabia's commercial banks, energy, food, and industrial companies. Across sovereign and corporate issuances, Saudi Arabia now represents 25 percent of the outstanding sukuk value globally.

Saudi Debt & Strategy

Following the economic shocks of COVID-19 and low oil prices, the Saudi government issued debt borrowings from domestic and external markets to fund subsidies and boost credit facilities to the private sector. In recent history, Saudi Arabia's deficit-to-GDP ratio reached a high of 15 percent in 2015 following a crash in oil prices and was steadily reduced to 4.5 percent in 2019. That ratio is expected to increase to 12 percent of GDP in 2020, primarily due to a decline in oil revenues. The government now forecasts a deficit of SAR298 billion ($79.5 billion) for 2020 compared to the SAR187 billion ($49.9 billion) projected in its budget before the COVID-19 pandemic. Saudi Arabia's total public debt is expected to reach SAR854 billion ($227.7 billion) by the end of 2020, representing 34.3 percent of GDP.

Albara'a Alwazir
Economist
alalwazir@ussaudi.org

Jacob Dichter
Research Analyst
jdichter@ussaudi.org

The downturn in revenue led the government to drawn down SAR48.7 billion ($13 billion) from its foreign reserves in the second quarter and a further SAR1.3 billion ($355 million) in the third quarter to finance the fiscal shortfall. However, the government primarily relied on further debt issuances totaling SAR207.2 billion ($55.3 billion) of which nearly a quarter, or SAR49.3 billion ($13.1 billion), came from riyal-denominated sukuk issuances through the end of Q3. The government raised its debt ceiling from 30 percent to 50 percent of GDP, signaling a preference to go to debt markets rather than further drawing down on its reserves.

Saudi Arabia's National Debt Management Center (NDMC), established in 2015, is the leading entity under the Ministry of Finance tasked with overseeing the Kingdom's public debt. Entering 2020, NDMC outlined the following risk management strategy for 2020: 1) ensure liquidity of the domestic debt market, 2) calibrate the refinancing of new securities to preserve the target average maturity of KSA debt, 3) emphasize fixed rate debts over floating rates, 4) minimize foreign exchange risk and explore non-USD international issuances based on market conditions, and 5) actively monitor sovereign credit rating metrics to maintain a strong credit rating. NDMC also outlined a 2020 calendar for local sukuk issuances in each month of the year and stated it would seek to maintain the current balance between domestic and external debt issuances (58 percent domestic, 42 percent international in 2019).

Despite the unanticipated fiscal and economic shock of the pandemic, the government largely adhered to its original borrowing plan and had the flexibility to expand issuance sizes due to strong investor appetite which persisted throughout the year. However, the government did rely more on domestic debt issuances (78 percent) than international issuances (22 percent) compared to the previous year. The government issued one SAR19 billion ($5 billion) sukuk/bond in the Eurobond market in January and another international sukuk/bond issuance in April that had mixed dollar/euro tranches worth SAR26 billion ($7 billion) while the remainder of publicly announced auctions were all riyal-denominated sukuk. The heavy reliance on domestic sukuk for deficit financing ensured ample liquidity in the Kingdom's domestic debt markets. The government also engaged in a SAR34 billion ($9 billion) early redemption exchange to take advantage of high investor interest and has maintained its strong credit rating (Moody's: A1, S&P: A-/A-2, Fitch: A) despite the impact on oil markets this year.

Saudi Arabia's Sukuk Program

The local currency sukuk program was launched in 2017 with the aim of diversifying funding as the Kingdom laid the groundwork for increased spending to boost Vision Realization Programs amid lower oil prices. The Ministry of Finance had originally planned to issue sukuk in the domestic market in 2015 but suspended the program due to tightening liquidity in the banking system. As credit and liquidity improved, the Ministry of Finance (through the NDMC) moved ahead with the program which has since seen strong investor interest and positive credit appraisals from international ratings agencies.

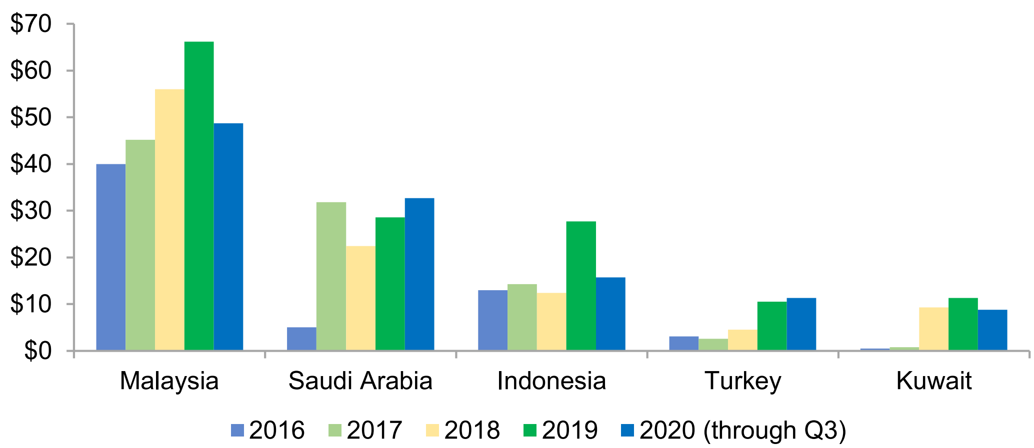
The local sukuk program is "credit positive for Saudi banks" due to the benefit of transferring larger, low-yielding cash reserves in banks to higher-yielding government sukuk while addressing a shortage of shariah-compliant liquidity instruments for Islamic banks, according to a Moody's report. In 2018, Saudi Arabia established a 'primary dealers initiative' by which five local banks – National Commercial Bank, Samba Financial Group (set to merge with NCB in H1 2021), Saudi British Bank, Bank Al-Jazira, and Alinma Bank – would purchase sukuk sold at auction directly from the government and later place the securities in the secondary market on the Tadawul for final investors. The purpose of the initiative was to broaden the investor base for government sukuk securities and take advantage of growing trading volume on the Tadawul.

Since then, the NDMC has maintained its commitment to primary dealers, introduced longer-term issuances of 12, 15, and 30 years to further establish a yield curve, reduced market transaction fees in coordination with the Capital Market Authority (CMA), and reduced the minimum sukuk subscription size from SAR1million ($267,000) to SAR1,000 ($267) to increase the demand base. These changes have led to the government's increased reliance on sukuk issuances to meet its financing needs. In 2019, Saudi Arabia financed over 50 percent of its fiscal deficit through sukuk and the riyal-denominated sukuk program has already reached a new high in 2020.

Global Sukuk Market

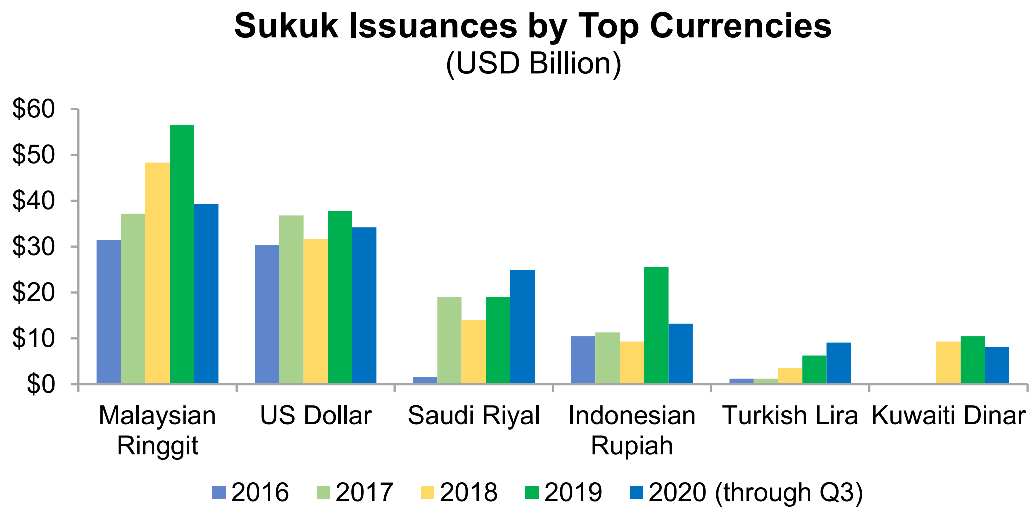
Global sukuk issuances totaled SAR508.1 billion ($135.5 billion) during the first nine months of 2020, rising 4.4 percent YoY. The full-year total is expected to pass last year's SAR637.5 billion ($170 billion) as governments navigate a new wave of coronavirus infections and the need for further lockdowns and economic support measures. Globally, Malaysia continues to be the leading issuer of sukuk. Malaysia, Saudi Arabia, and Indonesia account for nearly 80 percent of the outstanding value of sukuk while other GCC countries like Kuwait, UAE, and Bahrain are among the fastest growing sukuk markets.

Sukuk Issuances by Top Countries (2016- Q3 2020)
(USD Billion)



Source: Refinitiv

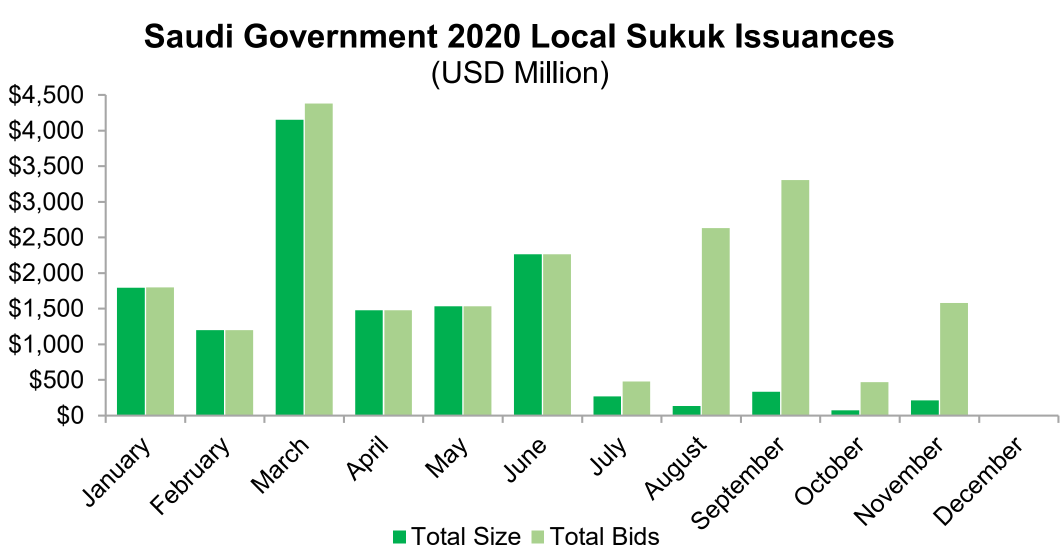
Saudi Arabia represents 25 percent of the market share of the global sukuk market with the government of Saudi Arabia ranking as the top sovereign sukuk issuer in 2020 so far. Comparatively, Malaysia represents 43 percent of the sukuk market share. Since the introduction of the local currency sukuk program, Saudi Arabia has consistently ranked as the second largest issuer of sukuk. Navigating low oil prices and fiscal consolidation, GCC countries were the leading source of growth in sukuk issuances among national markets. The Saudi government's reliance on its riyal-denominated program this year is evidenced by its surpassing the Indonesian rupiah through Q3 2020 as the third largest sukuk currency denomination.



Source: Refinitiv

Saudi Sukuk Breakdown

Saudi riyal-denominated sukuk issuances totaled SAR42.4 billion ($11.3 billion) in Q3, bringing the year-to-date total to SAR93.4 billion ($24.9 billion). This value is higher than any of the past four years as both sovereign and corporate issuances of riyal-denominated sukuk are on track to reach a new high in 2020. Most of the government's local sukuk issuances occurred during the first six months of 2020. The SAR46.6 billion ($12.4 billion) issued during H1 2020 largely reflected strong investor demand. In H2 2020, the Saudi government reduced the size of its domestic borrowing relative to the first half of the year and signaled it would not go to international debt markets again in 2020. Throughout H2 2020, investor demand outpaced the size of issuances ranging from 80 percent in July to nearly 20 times the actual size in August. The government is expected to close a final round of local sukuk issuances in December.



Source: Ministry of Finance

The weighted average of the final profit rates of local sukuk issuances in 2020 was 2.99 percent. While only four tranches of the 24 issued through November had a final profit rate at 3 percent or higher, these counted as some of the largest issuances of the year. Notably, the government issued its second 30-year sukuk in March with a size of SAR14.9 billion ($4 billion) and a final profit rate of 3.68 percent. All other local issuances were between 1.73 percent and 3.1 percent. The 30-year tranche in March was the largest issuance of the year, bringing the weighted average maturity to 2036 while the average maturity excluding that tranche is 2030.

The average issuance size through November was SAR5 billion ($1.3 billion) with an average tranche size of SAR2.1 billion ($560 million). Sukuk, which differ from conventional bonds in that they theoretically represent ownership of a tangible underlying asset and are therefore sharia-compliant, have several different financing mechanisms. The structure of sovereign sukuk in Saudi Arabia are predominantly Istithmar, Murabaha, or hybrid while corporate sukuk in Saudi Arabia tend to be Wakala bil istithmar, Ijara, hybrid, or other. Saudi Electricity Company's SAR4.9 billion ($1.3 billion) green sukuk was Ijara, for example, which connotes certificates or entitlement to particular assets granted to investors.

Sovereign sukuk issuances are still the main contributor to the sukuk market both in Saudi Arabia and globally, but there has been a pickup in corporate sukuk activity in recent years. Saudi banks were the top corporate issuers of sukuk in the Kingdom this year as Banque Saudi Fransi, National Commercial Bank, Saudi British Bank, and Arab National Bank issued a combined SAR17 billion ($4.5 billion). In recent years, companies including Saudi Aramco, Almarai, Savola Group, Arabian Centres, STC, and others have closed multi-billion-dollar sukuk rounds. Unlike the sovereign push towards riyal-denominated sukuk, corporate issuances in Saudi Arabia are predominantly listed in the Eurobond market through special-purpose vehicles that are either dollar or euro-denominated.

U.S., Saudi, and international banks play a leading role in the growing sukuk market as the bookrunners and arrangers for large-scale debt issuances. Citi and JP Morgan have 5.1 percent and 2.9 percent of the international Islamic finance market share, respectively. Morgan Stanley and Citi were two of the leading companies running the Kingdom's SAR18.8 billion ($5 billion) international issuance in January while the five Saudi primary dealer banks have well-established relationships with the government through the domestic sukuk program.

Outlook

Consistent with the NDMC's 2020 calendar, one additional sukuk issuance is expected in December and no additional international borrowing this year. The Ministry of Finance projects the budget deficit will decline to 4.9 percent of GDP in 2021 due to a decrease in spending, an expected recovery in oil revenue, and growth in non-oil revenue. Public debt is expected to increase by SAR83 billion ($22.1 billion) in 2021 while GDP is expected to rebound 3.2 percent, leading to a 32.7 percent expected debt-to-GDP ratio next year.

A natural consequence of the Saudi government's decision to go to debt markets to finance the Kingdom's deficit is that sizable issuances will be due over the next several years. It will be critically important for the Kingdom to maintain its fiscal buffers, primarily in foreign reserves, that allow it to

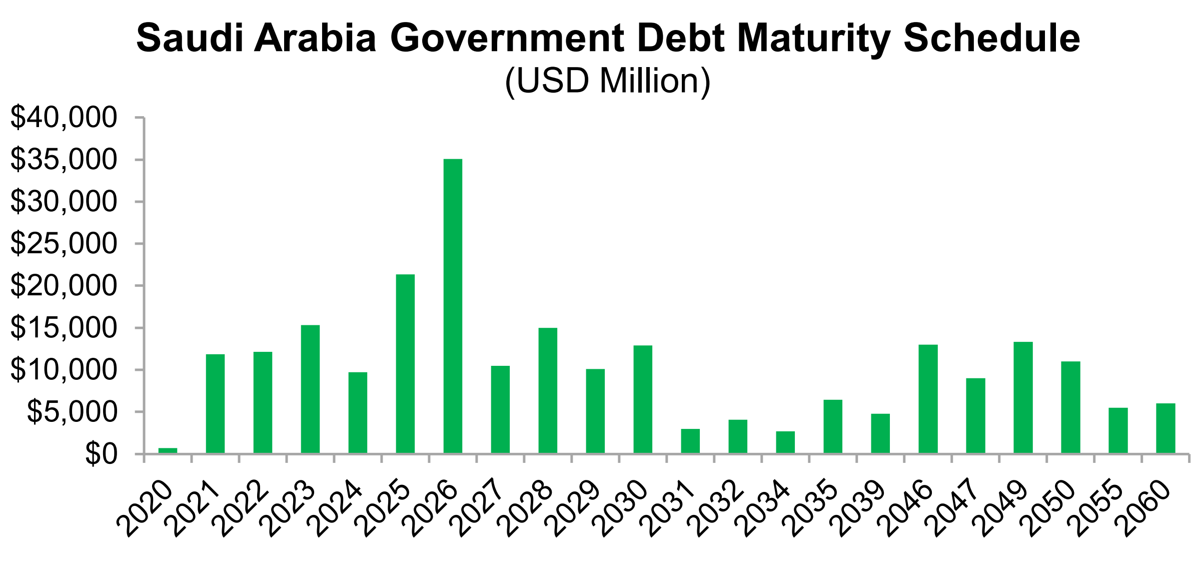
In Focus: Saudi Arabia's First 'Green Sukuk'

Saudi Arabia joined a growing movement of green financing when Saudi Electricity Company (SEC) sold the first two-tranche green sukuk worth SAR4.9 billion ($1.3 billion) to finance its 10-million smart meter project and other renewable energy projects. The first tranche was sized at SAR2.4 billion ($650 million) with a 5-year tenor and a 1.74 percent final profit rate while the second tranche was an equally sized SAR2.4 billion ($650 million) with a 1-year tenor and a 2.41 final profit rate. The green sukuk was dollar-denominated and issued in the Eurobond market. Green sukuk have primarily been seen in the corporate sector with Indonesia and Malaysia leading other nations in the depth of their green Islamic financing regime.

SEC is Saudi Arabia's primary utility entity providing generation, transmission, and distribution of electricity within Saudi Arabia, accounting for 70 percent of the electricity generation capacity across the Kingdom in 2019. In line with the government's Vision 2030 initiatives and U.N. Sustainable Development Goals, SEC has adopted a sustainability framework focusing on the research and development of renewable energy projects to grow renewable capacity to 27.6 gigawatts (GW) by 2025. SEC's Green Sukuk Framework was established in line with 'Green Bond Principles' issued by the International Capital Market Association (ICMA) in 2018 that outline criteria for reporting the use and management of proceeds, project selection and evaluation, and external review.

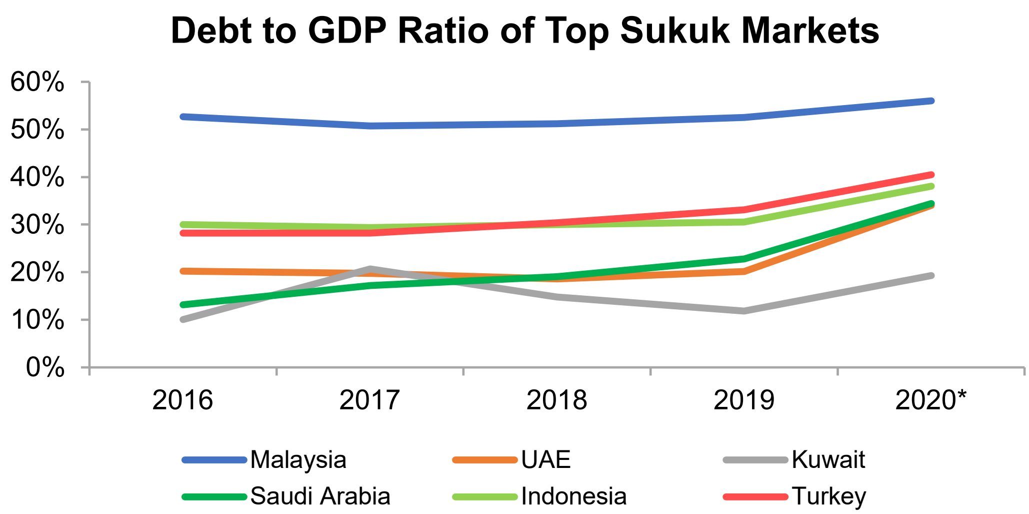
SEC will primarily use the proceeds of its green sukuk for a large-scale 10-million smart meter project as well as the array of solar and wind projects from Round 2 and 3 of the Renewable Energy Project Development Office (REPDO) pipeline, covered in our June Economic Brief. Saudi Arabia's first green sukuk issuance was nearly four times oversubscribed by investors across Asia, Europe, and the Middle East. As commercial banks become more conscious about their Environmental, Social, and Corporate Governance (ESG) standing, green lending is expected to constitute a growing segment of bank corporate activity.

withstand potential economic shocks and maintain a strong credit rating. In October, Moody's affirmed its A1 rating of Saudi Arabia's medium-term note program and a A1/Aaa.sa credit rating of Saudi Arabia's domestic sukuk market, describing it as "working increasingly well." On the financial market side, Saudi Arabia launched its first two exchange-traded funds (ETFs) for government sukuk and recently had its international issuances added to the JPMorgan Emerging Market Bond Index. The government's secondary market strategy for sovereign sukuk issuances has allowed for further development of its capital markets.



Source: Ministry of Finance, Refinitiv

The NDMC will likely maintain a commitment to increasing its international investor base, particularly in Asia, and consider other international issuances depending on market conditions. Despite the Kingdom's transition towards deficit spending in recent years, it maintains a relatively low debt-to-GDP ratio relative to other G20 economies and other major sovereign sukuk markets. Malaysia, for example, the global leader in sukuk, is expected to register a 56 percent debt-to-GDP ratio in 2020 while Saudi Arabia anticipates its debt-to-GDP ratio to reach 34 percent before declining over the medium-term. This fiscal position gives the government continued flexibility in addressing its funding needs through debt markets while maintaining robust foreign reserves.



* Expected
Source: Ministry of Finance, TradingEconomics, Refinitiv