Policy Note: PN 2102

Introduction of Sovereign Investment *Ṣukūk* in Bangladesh and Liquidity Management by Islamic Banks

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Chief Economist's Unit
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Abstract

The first sovereign investment ṣukūk[2] in Bangladesh for implementing a project titled 'Safe Water Supply for the Whole Country' got huge response and was over-subscribed, which signals that investing in ṣukūk is a potential sector in the financial market of the country. This note explains the structure of the maiden ṣukūk in order to understand further scopes of developing such types of ṣukūk in the country, considering huge excess liquidity in Islamic banking sector. The note also finds that excess liquidity of Islamic banking sector remains a concern and issuing ṣukūk can help them purchase the Shariah- compliant securities for maintaining their statutory liquidity ratio (SLR) with the Bangladesh Bank as well as investing in government's development projects. Moreover, asset backed ṣukūk with ijārah, muḍārabah or mushārakah contracts can be considered to introduce more sovereign investment ṣukūk which can be used for implementing Sharīʿah-compliant government development projects. The note also recommends that there is a need for supportive policies to the investors for encouraging the investment in ṣukūk.

I. Introduction

Bangladesh issued first sovereign investment *ṣukūk* for raising funds aiming at implementing a project titled 'Safe Water Supply for the Whole Country' on 28 December 2020. The maiden *ṣukūk* was over-subscribed by nearly four times, signaling that investing in such *ṣukūk* is a new potential avenue for the financial markets of Bangladesh. Likewise the growing share of Islamic banking in Bangladesh, the huge oversubscription of this maiden *ṣukūk* reflected investors' interest to Islamic financial products of capital market. Besides, the issuance of such *ṣukūk* provides a scope for the government of Bangladesh to explore for financing its Sharīʿah-compliant projects.

Moreover, current huge excess liquidity with Islamic banks is exerting adverse effects since the Islamic banks cannot invest in interest-bearing government securities because of non-Sharīʿah-compliance issues. The newly issued *ṣukūk* also offers an avenue of investing the excess liquid assets into such Sharīʿah-compliant securities. Against this backdrop, this policy note explains the structure of the maiden *ṣukūk* in order to delve further scopes of developing such types of *ṣukūk* in the country, considering huge excess liquidity in Islamic banking sector.

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[2] *Ṣukūk* is the plural of Arabic word *sakk*. In Arabic language, *ṣukūk* mean 'legal instrument', 'deed' or 'check'. In Islamic financial concept, *ṣukūk* refer to Sharīʻah-compliant financing instruments, which differ from conventional bonds in terms of structure, rate, legal rights and the underlying contracts, among others. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines that *ṣukūk* are the certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity.

II. The newly issued *Ṣukūk* and its Structure

The government planned to raise BDT 80 billion through issuing *ṣukūk* for implementation of a five-year 'Safe Water Supply to the Whole Country' project which began in January, 2021[3]. Three parties, which are originator, special purpose vehicle (SPV) and investors, are involved in the operations of the *ṣukūk*. Bangladesh Bank (BB) acts as a SPV on behalf of Ministry of Finance, the originator of the Sharīʿah-compliant *ṣukūk*, arranged first auction of BDT 40 billion *ijārah ṣukūk* on 28 December 2020, with a 5-year maturity period. The first auction got responses from 37 institutions — both conventional and Sharīʿah-compliant financial institutions and two individuals — and was over-subscribed to BDT 151.53 billion. There are two tranches, with BDT 40 billion in each tranche. The BB will arrange the next auction for the remaining tranche of BDT 40 billion on 28 June 2021.

The underlying contract of such *ṣukūk* is based on *ijārah* in nature. The existing and future asset including usufruct under the project ''Safe Water Supply to the Whole Country' of the government are the *ṣukūk* asset to be leased to the *ṣukūk* investors. Rental rates of the *ṣukūk* will be transferred to the investors in the form of coupon payments. According to the guidelines on the investment criteria of the new *ṣukūk*, investors will receive 4.69 percent as rental rate on their investment in such *ṣukūk*, which will be paid by the BB on behalf of the government on a half-yearly basis. The BB has fixed the rate based on the latest rate on Bangladesh Government Islamic Investment Bond (GIIB) which paid 3.69 percent as profit in 2019 and accordingly, the BB added just 1 percent to the rate of the maiden *ṣukūk*. A single investor must invest at least BDT 10,000 in such *ṣukūk*, without any upper limit. The Department of Public Health Engineering (DPHE) is implementing the project funded by the *ṣukūk* issuance and is going to complete the project by 30 June 2025.

III. Implication of the newly issued *ṣukūk* on the financial sector

The overwhelming response for that *ṣukūk* may be attributed to existence of excess liquidity surplus of Islamic banks. Since Islamic banks cannot invest their excess funds in interest bearing securities and since there are only limited available Sharīʿah-compliant securities, that *ṣukūk* has given a scope to assist the Islamic banks in managing their liquidity to some extent. Not only such *ṣukūk* is mopping up the excess liquid assets from the Islamic banks, but also government is implementing its project by introducing such *ṣukūk*, which will, in fact, help resource mobilization and fiscal management.

Further, Islamic banks of Bangladesh have to maintain their statutory liquidity ratio (SLR) with the BB, but the government securities to purchase for maintaining the SLR are mostly not Sharīʿah-compliant. Currently, Islamic banks are required to maintain at least 5.5 percent of their total demand and time liabilities, excluding inter-bank items, effective from 1 February 2014, which remained unchanged till date. On the other hand, conventional banks are required to maintain 13.0 percent of their total demand and time liabilities. Lower requirement for the Islamic banks is because of the lack of available Sharīʿah-compliant government securities for them, but may raise an issue of market perfection between Islamic and conventional banks. Issuance of more sovereign *ṣukūk* instruments by which the banks will have broader space to maintain SLR will help rationalize the requirement for Islamic banks in future.

However, in the financial sector, Bangladesh Government Islamic Investment Bond (GIIB), so far, is the only approved Sharīʿah-compliant security other than the newly issued *ṣukūk* in order to maintain

[3] Government of Bangladesh and Bangladesh Bank (2019). Prospectus – The offer of *ijārah ṣukūk* – Safe water for the whole country. (https://www.bb.org.bd/mediaroom/notice/ṣukūk_prospectus.pdf)

the SLR by the Islamic banks. But the limitation of the GIIB is that the government cannot borrow money from GIIB fund as the fund must be used in the Sharīʿah-compliant projects, and there is no mechanism to do so. Therefore, in return, the Islamic banks with liquidity shortfall borrow funds from this pool of GIIB which was collected earlier through selling of the GIIB securities. Here, *muḍārabah* principle is the underlying contract followed for such financing by the security holders and Islamic banks avail this fund at a provisional rate of profit on its *muḍārabah* short notice deposit accounts, with an adjustment after finalization of accounts and rate of profit of the concerned Islamic banks. However, still a significant balance (= sale – financing) remained always idle in government account without incurring any benefit, indicating that there is a scope of financing this balance in Sharīʿah-compliant ways. Table 1 shows the trend of sale, financing and net balance over the periods during FY10-FY20.

Table 1: Bangladesh Government Islamic Investment Bond

(Billion BDT)

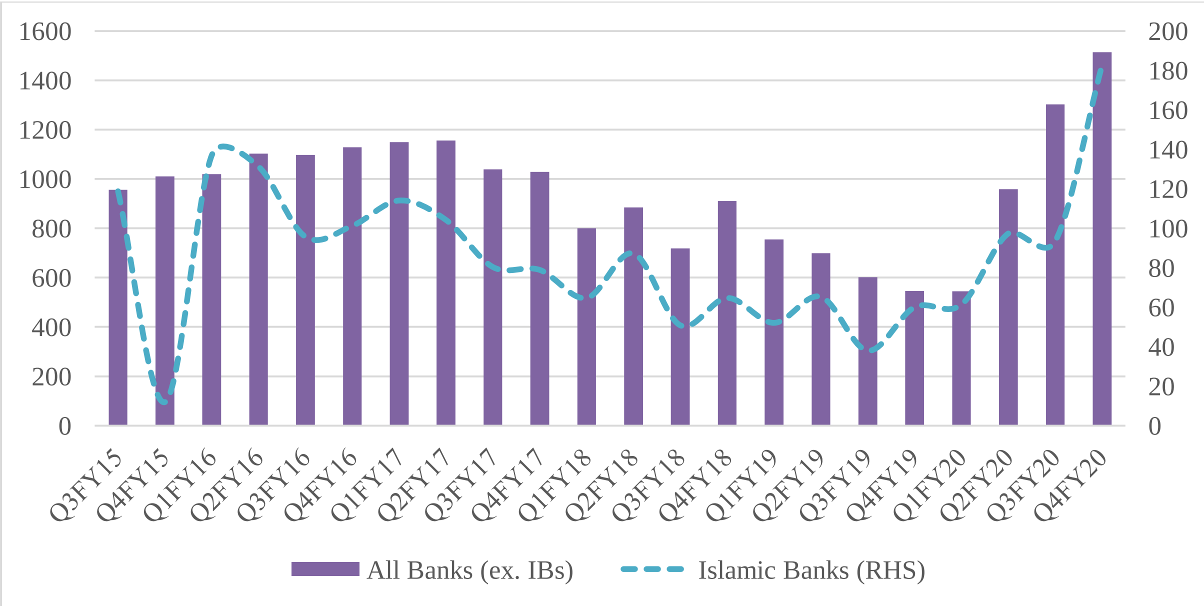
Fiscal year	Sale	Financing	Net balance
FY10	23.40	15.40	8.00
FY11	25.30	22.80	2.50
FY12	31.48	31.26	0.22
FY13	107.13	67.78	39.35
FY14	121.34	24.37	96.96
FY15	135.84	25.40	110.44
FY16	122.94	37.80	85.95
FY17	84.01	54.70	29.31
FY18	92.95	81.20	11.75
FY19	107.11	84.80	22.31
FY20	131.88	67.82	64.06

Source: Various Annual Reports, Bangladesh Bank

IV. Excess liquidity of Islamic banks and scope for investing in *ṣukūk*

Excess liquid assets of Islamic banks have been increasing gradually overtime with some ups and down as evident in Chart 1. At the end of Q4FY20, the total amount of excess liquid assets of Islamic banks hit record at BDT 183 billion, while conventional banks' excess liquid assets accumulated to BDT 1514 billion at the end of same quarter. Lower investment or financing in case of both Islamic and conventional banks reflected in slower private sector credit growth in the wake of COVID-19 situation expanded the excess liquid assets in the recent periods. However, while conventional banks have broader scopes of investing their excess liquid assets in treasury bills and bonds, Islamic banks have only two options - the GIIB or newly issued *ṣukūk*.

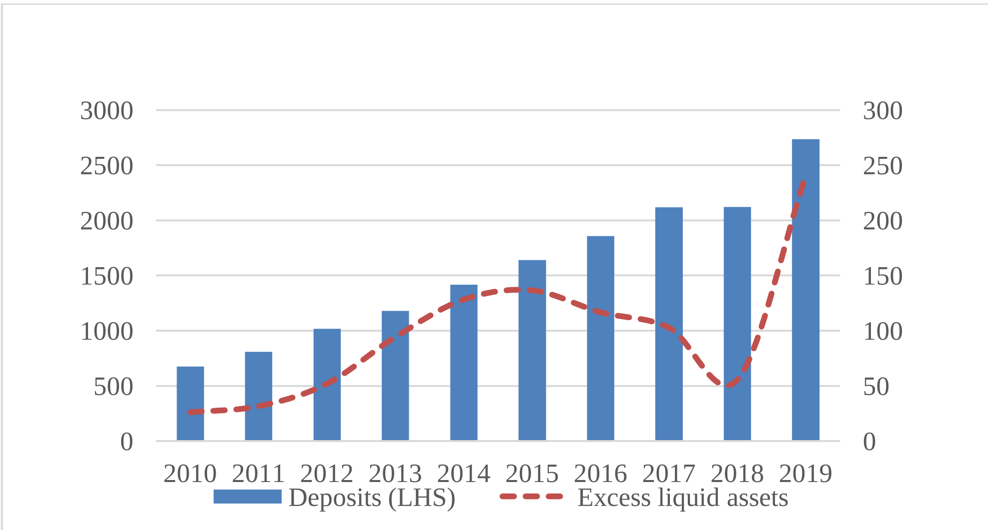
Chart 1: Excess liquid assets of conventional banks (excluding Islamic) and Islamic banks (in billion BDT)



Source: Bangladesh Bank

Chart 2 also shows an overall positive relationship between deposits and excess liquid assets of Islamic banks over the years but 2016, 2017 and 2018. During 2016-2018, the Islamic banks had granted aggressive investments reflected in investment - deposit ratios, which were close to 90 percent or more. Since Islamic banks have historical excess liquidity experience with an absence of available sovereign Sharīʿah-compliant securities, they have a tendency to make over-investments which, sometimes, remains a concern for bank's resilience against any adverse situation. The BB, at that time, took some special measures for Islamic banks to reduce the investment-deposit ratio. The excess liquid assets escalated again in 2019 stood at BDT 240.5 billion, while total deposits of Islamic banks increased too. This implies that innovative securities for Islamic financial system are critical to absorb the excess liquidity of Islamic banks.

Chart 2: Total deposits and excess liquid of Islamic banking (in billion BDT)

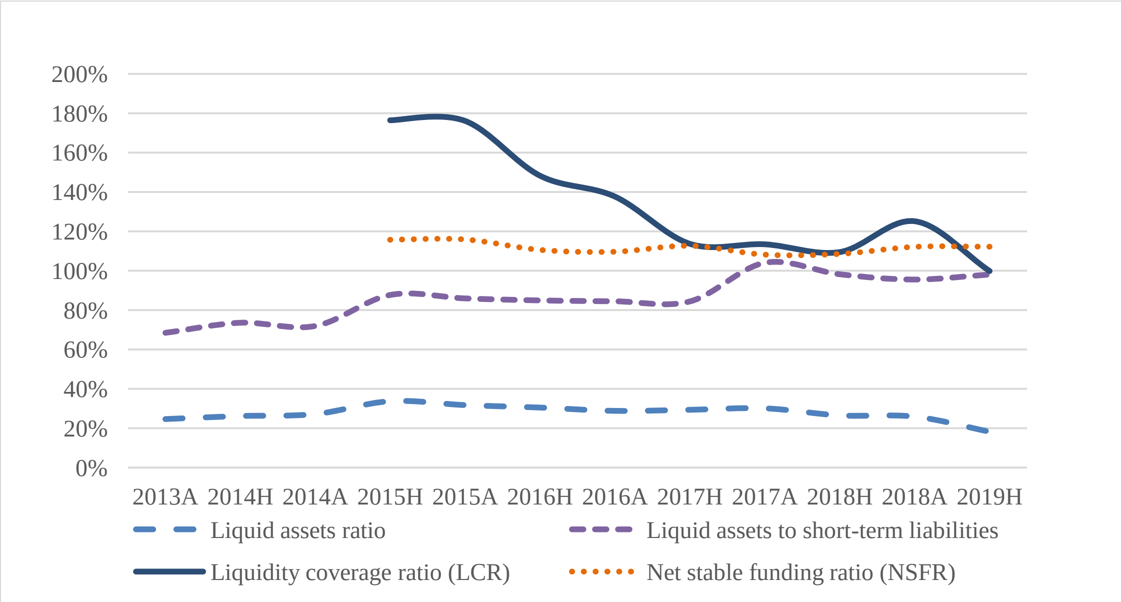


Source: Various Annual Reports, Bangladesh Bank

V. Liquidity indicators of Islamic banks

Liquidity indicators indicate the capability of Islamic banking sector to its short-term financial obligations. Chart 3 shows that the liquid asset ratio calculated by taking liquid assets as numerator and total assets as denominator maintained always more than 20 percent except 2019H, reflecting available liquidity to meet expected and unexpected demands for cash. Liquid assets to short-term liabilities calculated by taking liquid assets as the numerator and short-term liabilities as the denominator show an upward trend and reached 98.1 percent in 2019H, indicating available adequacy to meet short-term withdrawals of funds without facing liquidity problems.

Chart 3: Liquidity of Islamic banks



Source: Prudential and Structural Islamic Financial Indicators (PSIFIs), Islamic Financial Services Board.

Basel Committee on Banking Supervision (BCBS)[4] developed a global liquidity indictor, the liquidity coverage ratio (LCR), to understand the capacity of high-quality liquid assets against possibility of cash outflows over the next 30 calendar days. The LCR maintained near about 100 percent during the reported periods indicates that Islamic banking sector in Bangladesh has sufficient liquidity against any financial crisis. BCBS developed another liquidity indicator, net stable funding ratio (NSFR), which is ratio of amount of available stable funding (ASF) to the amount of required stable funding (RSF), intending to encourage banks to develop access to medium- and long-term funding. According to BCBS guidelines, the ratio must be more than 100 percent and Islamic banking sector of Bangladesh maintained the ratio well above 100 percent during the reported periods, which indicates that Islamic banks have sufficient sources of funds over a one-year time horizon under the conditions of financial stress.

VI. Possible underlying contracts for issuing new *ṣukūk* in Bangladesh

Ṣukūk can be developed based on different underlying Sharīʿah-compliant contracts, such as partnership, lease, agency and sale contracts. In the context of Bangladesh's financing systems, the following three major contracts can be considered for issuing new *ṣukūk*.

[4] Basel Committee on Banking Supervision (2014). Liquidity coverage ratio disclosure standards. Basel: BCBS.

***Ijārah ṣukūk* for medium- and long-term government financing:** This is one of the most common *ṣukūk* issuance, especially for project finance. The newly issued *ṣukūk* on safe water corresponds to *ijārah* contract. *Ijārah ṣukūk* is a leasing structure coupled with a right available to the lessee to purchase the asset at the end of the lease period. The rental rates of return on those *ṣukūk* can be fixed or floating depending on the agreement. The cash flow from the lease including rental payments and principal repayments are passed through to investors in the form of coupon and principal payments. Like the newly issued *ṣukūk*, *ijārah ṣukūk* provides an efficient medium to long-term mode of financing for Bangladesh economy. The major benefit of the *ijārah* contract is that government as a lessee can lease an asset only for a certain period of time, paying rent against the asset. Even the period is long, the *ṣukūk* holders, on the other hand, can sell the certificates, if needed.

***Muḍārabah ṣukūk* for investing in government's Sharīʿah-compliant projects:** This is an agreement made between two parties, where one party provides the capital (rab-al-maal) and the other is an entrepreneur (muḍārib). The contract enables the entrepreneur to carry out business projects on a profit-sharing basis, according to pre-determined ratios agreed earlier. In the case of losses, the losses are borne by the provider of the funds only. Currently, GIIB certificates are being operated under *muḍārabah* contract. Government can find the way to issue more *muḍārabah ṣukūk* in the market. However, unlike GIIB, it is important to find out way how *muḍārabah* fund can be utilized for government's Sharīʿah-compliant projects.

***Mushārakah ṣukūk* for developing PPP projects:** This is very similar to the *muḍārabah* contract and is widely used in equity financing. The structure of *mushārakah* requires both parties to provide financing to the projects. In case of losses, both parties will lose in proportion to the size of their investment. Government's public private partnership (PPP) projects can be considered under *mushārakah ṣukūk* for raising required financing for infrastructure development.

VII. Conclusion

The maiden *ṣukūk* has drawn huge response from investors as it was over-subscribed, indicating that government can be benefitted further by introducing such types of *ṣukūk*. To continue GDP growth rates to high levels as targeted by the government, the economy needs to implement huge infrastructure development projects in which policymakers need to consider on how *ṣukūk* instruments can be used in government Sharīʿah-compliant projects.

Excess liquidity of Islamic banking sector remains a concern and issuing *ṣukūk* can help them purchase the Sharīʿah-compliant securities for maintaining their SLR as well as for contributing to economic development of the country. At this stage, this note finds that asset backed *ṣukūk* with *ijārah*, *muḍārabah* or *mushārakah* contracts can be initiated against other Sharīʿah-compliant government projects.

Moreover, there is a need for supportive policies for encouraging the investment in *ṣukūk*. For instance, current tax structure of a 5 percent source tax on profit may discourage investors from parking their funds in Sharīʿah-compliant securities. To make the Sharīʿah-compliant securities more attractive, tax authority may take appropriate measures, treating *ṣukūk* on how they can be exempted from taxes.