A REVIEW ON THE POTENTIAL GROWTH OF SUKUK, ISSUES AND ITS CHALLENGES

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ABSTRACT

As in 2015, Malaysia has pioneered in the development of global *sukuk* market accounting for 54.3% of the global *sukuk* outstanding. The growth of the *sukuk* market in Malaysia is supported by a comprehensive infrastructure including the reporting, trading and settlement system which has resulted in an active primary *sukuk* market. The issuance of *sukuk* is regulated under Security Commission(SC) in Malaysia through the framework provider under the guideline of *sukuk*. Furthermore, the growth of *sukuk is* supported by the value of*sukuk* itself whereby the issuance of *sukuk* is not only an exchange of paper for money with the imposition of interest as practice by conventional bond but rather an exchange of shariah compliance asset for some consideration applying various Shariah principles. Therefore, this paper attempt to explore the potential growth of *sukuk* in the global area. Nevertheless, during the growth of *sukuk* there is criticism and challenges faced in the *sukuk* market. Thus, it is crucial to address several issues and challenges in the *sukuk.*

Keywords: *Sukuk growth, issues and challenges*

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1. Introduction

The Development of Sukuk Market

The Islamic finance industry has witnessed significant developments and that includes *sukuk* market. In Malaysia, *sukuks* were first innovated in the early 1990s. The *sukuk* market was recognized as a substitute to conventional bonds in terms of its features as a fixed income instrument with preservation of the capital. According to IMF World Economic Outlook 2015, global growth is projected to increase slightly from 3.4% in 2014 to 3.5% in 2015, supported by lower inflation, accommodative monetary conditions and sustained growth in global trade. The global *sukuk* issuance according to the countries as at 1st quarter 2015 can be illustrated as below.

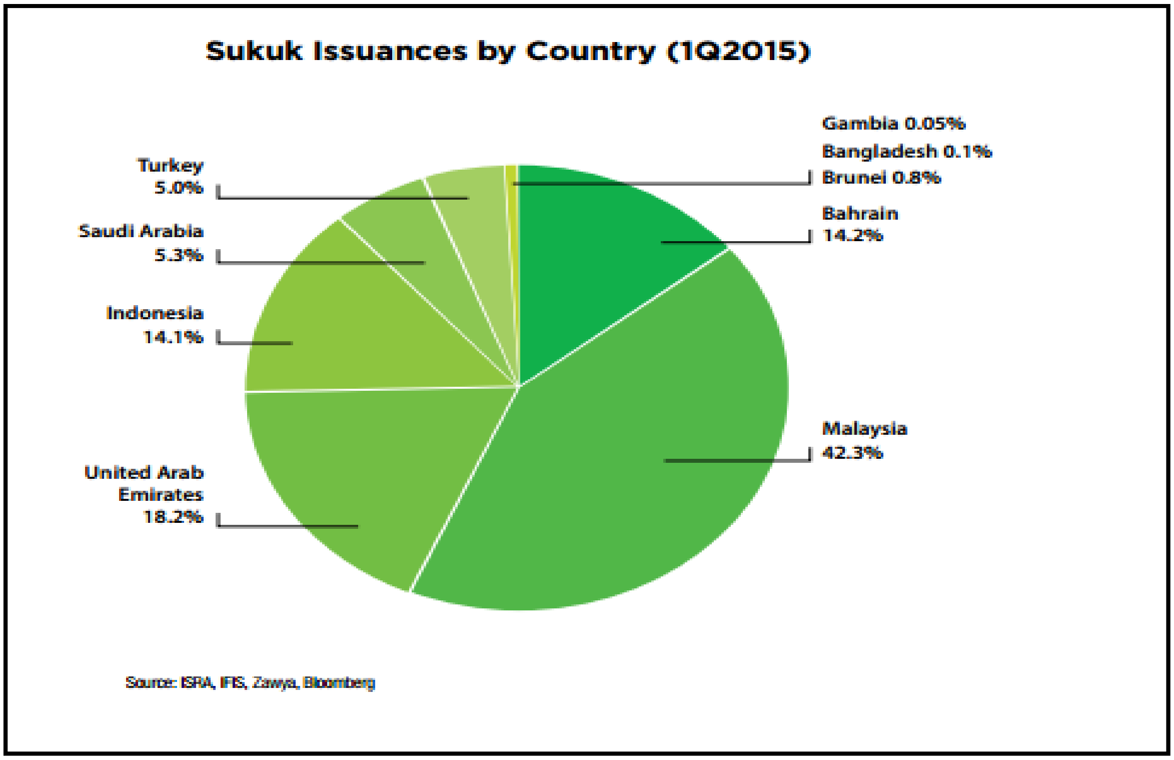


Figure 1. *Sukuk* Issuance by Countries

From the Figure 1, in 2015, Malaysia has plays a dominant position in the global market with 42.3% *sukuk* issuance as compared to other countries. The second *sukuk* issuer dominates by United Arab Emirates with the percentage of 18.2% and the small issuer of sukuk was Brunei. However, statistic from IIFM Sukuk Database shows that the issuance of *sukuk* is slightly lower in 2014 and 2015 compared to the year 2012 and 2013. The total numbers of *sukuk* issuance shows as in Figure 2.

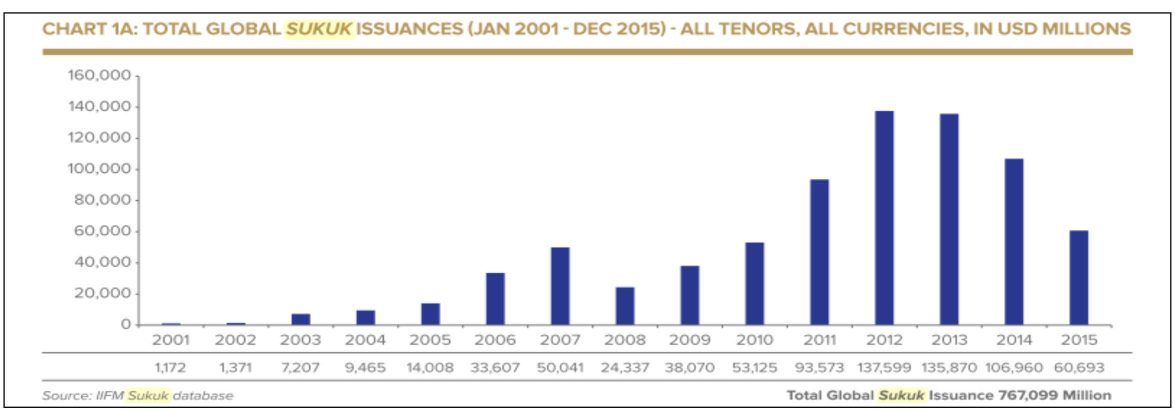


Figure 2. Global Issuance of *Sukuk*

Based on the Figure 2, year of 2012 and 2013 record the highest years for global *sukuk* issuances while in 2014 the *sukuk* market slowed down to just over USD100 billion issuances. For the year 2015, itwitnessed a major drop in issuances when only USD60.6 billion *sukuk* were issued, a massive 43% decline compared to 2014. However, this major declining is due to BNM policy decision to discontinue issuance of short-term investment *sukuk* and this may not be taken as a reflection of weakness in the *sukuk* market but a change of strategy.

As seen in the past study, activity in the global *sukuk* market is closely tied to the sentiment on global economic and financial sector. Several factors have been identified as key drivers of global *sukuk* growth as shown in Figure 3.

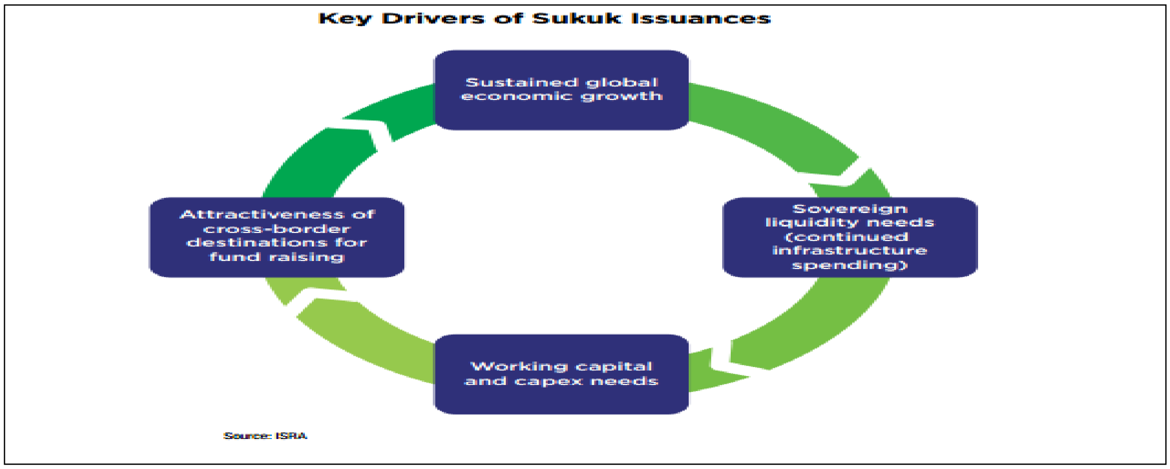


Figure 3. Key Factors for The Growth of *Sukuk*

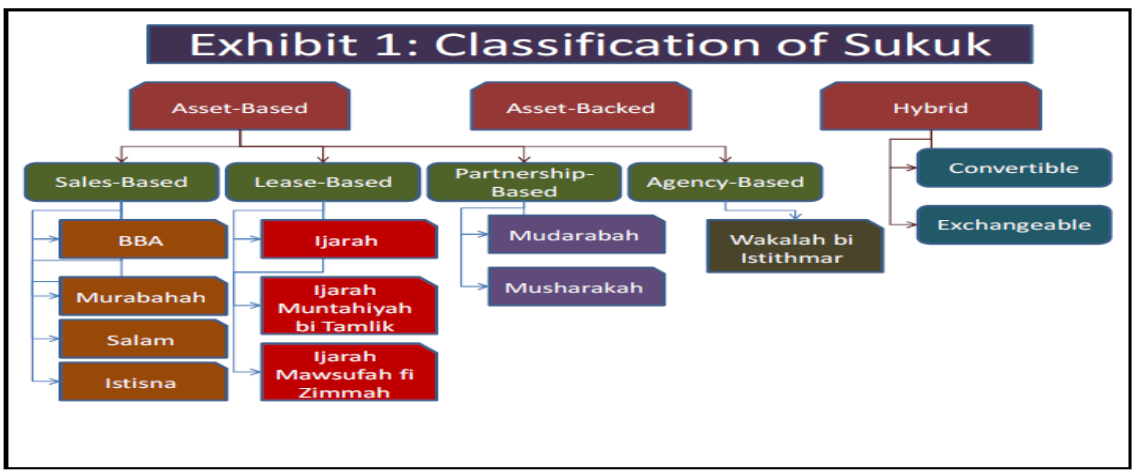
Figure 3 indicates that four factors that contribute to the growth of global *sukuk* market are sustainable global economic growth, the destination or location for the fund raising, working capital and capex and sovereign liquidity needs. Despite these four factors, studies by Chermi & Jerbi (2015) address other key of success factors for *sukuk* market in Malaysia. The first key factor is the establishment of strong and highly developed regulatory and legal framework. Bank Negara Malaysia (BNM) and Securities Commission (SC) act as the highest main authorities that govern the legal infrastructure. The issuance of Islamic securities, including *sukuk*, is subject to the requirements stipulated in the Securities Commission's Guideline on the offering of Islamic Securities. These two institutions offer a wide and clear range of regulations that help to organize and standardize the *sukuk* market activities and the whole Islamic financial system in general.

Second key factor is well-defined shariah governance framework that plays a prominent role in the development of Islamic finance and the *sukuk* market, in particular. Each of Islamic financial institution has its own advisory council that works under the authority of the SAC of Bank Negara Malaysia. The rulings for all *sukuk* issuance are based on certain Shariah's criteria. In year 2014, Malaysia has sets a new guideline in issuing *sukuk* to ensure the operation of *sukuk* fulfils the shariah compliance. Third key factor is Malaysia as an attractive cross border destination for fund raising with support by a comprehensive Islamic Financial Infrastructure and well-established Islamic financial system. Moreover, the prominence of Malaysia's *sukuk* market in the past has been largely driven by the strong demand from the private sector in funding the nation's infrastructure development projects.

Fourth key factor is the proliferation of new types of instruments with extended maturity profiles has generated a diversified range of players, both local and foreign, to participate in the market (Mohd Zin, 2011). Last but not lease is the effort of Malaysian government to offer various incentives to support the *sukuk* market such as several tax, regulatory privileges and the establishment of MIFC to boost the *sukuk* market. All these factors have led to the rapid development of *sukuk* in Malaysia. *Sukuk* allows government to access a new investor base by diversifying their sources of fiscal funding. *Sukuk* issued to foreign investors can help to cover external financing needs and support reserve building.

2. The Classification of *Sukuk*

Sukuk are structured based on the specific contract of exchange of Shariah-compliant assets. *Sukuk* has also known as asset based instruments. It can be classified into three types of *sukuk* as shows as at Figure 4.



Source: (Securities Commission, 2009)

Figure 4. Categories of *Sukuk*

According to the above structure, three main categories of *sukuk* are asset backed *sukuk*, asset based *sukuk* and hybrid *sukuk*. A number of discussions by previous studies on the comparing between *sukuk* and conventional bond. Ramasamy et al. (2011) confirmed that *sukuk* are less risky compared to bonds and provides better yield to the investor. Furthermore, (Zin et al., 2011) also discussed on the comparison between bond and *sukuk*. The authors justify that *sukuk* has been structured and the issue is not the exchange of money with the certificate alone but it is based on the exchange of assets that have been approved with a few scales, which funding will enable investors to receive profits from the transaction. Hence, it is proven that the practice of *sukuk* contradicts with trading debt in conventional market. In conventional market exchange paper for money with the imposition of an interest but *sukuk* exchange of Shariah-compliant asset for some financial consideration applying various shariah principles, for example, *bai' bithamanajil* (BBA), *murabahah, ijarah, mudharabah and musharakah* that allow investors to earn profits from the transactions.

Generally, majority *sukuk* in the market was issued based on the asset based *sukuk* compared to asset backed *sukuk*. In Malaysia, before the issuance of the Islamic Securities Guideline in 2004, *sukuk* has to represent debt. However, with this new guideline, *sukuk* can be represented as debt or non-debt assets as the underlying instruments ISRA (2012). Ismail & Ali, (2008) addressed that the use of Malaysian asset backed *sukuk* can represent an effective form of cheaper long-term financing for Malaysian companies. Invariably, the underlying asset in an Islamic asset-backed transaction cannot contain any elements that contradict shariah. For that reasons, Malaysian Global *Sukuk* received worldwide shariah compliance endorsement and the *sukuks* are accepted in major markets in Bahrain, Middle East and Europe. Furthermore, with the asset backed sukuk the credit risk will be solely determined by the performance and credit quality of the underlying asset. Meanwhile, asset-based *sukuk* means the asset is present for the purpose of shariah fulfilment rather than to serve as a source of profit and capital payment. The credit risk assessment will typically be directed towards the entity with the obligation to redeem the *sukuk.*

In addition, several studies attempt to compare between asset backed *sukuk* and asset based *sukuk*. Islamic Financial Services Board (IFSB) elaborates on two types of asset-based *sukuk*. Firstly, *sukuk* utilize a purchase undertaking from the originator and secondly, *sukuk* with a guarantee from the issuer in case the originator defaults. Based on the IFSB definition, it was made apparent that asset-based *sukuk* implies that the *sukuk*-holders have recourse to either the originator via the purchase undertaking or the issuer via the guarantee. In other words, asset-backed *sukuk* involve full transfer of legal ownership of the underlying asset while asset-based *sukuk* involve recourse to the originator or the issuer but not the asset (Asyraf Wajdi Dusuki, 2010). Likewise, Rating Agency Malaysia (RAM) has a similar definition of asset- backed and asset-based *sukuk*. According to RAM, asset-backed *sukuk* are "characteristically non-recourse *sukuk*, with the underlying assets forming the lone source of profit and capital payments (Mohd Noor, 2008). For asset based *sukuk*, s*ukuks* are structured as participation certificates that provide investors with a share of asset returns making them compatible with the Islamic prohibition of interest payments. However, studies by Ariff, Safari, & Mohamed, (2013) despite market associates significantly has higher risks to *sukuk* securities compared than to conventional bonds, *sukuk* observed higher returns.

Another category of *sukuk* is hybrid *Sukuk.* Hybrid *sukuk* was introduced in the market to enhance the mobilization of funds as it allows the use of shariah-compatible financing contracts for refinancing means. In a hybrid *sukuk* structure, the originator will transfer tangible asset to the special purpose vehicle. In turn, the Special Purpose Vehicle(SPV) issues *sukuk* to investors and receives *sukuk* proceeds from them. The proceeds are used to pay the originator, while the revenues realized from the underlying assets are paid through to the *sukuk* holders. At maturity, the originator purchases back the underlying assets from the SPV, while the *sukuk* holders receive fixed payment of return on asset and the *sukuk* are paid off. The first issuance hybrid *sukuk* was issued by Islamic Development Bank comprising 65.5% *Sukuk Al Ijarah*, 30.73% *Murabahah* receivables and 3.4% *Sukuk Al Istisna.* Nevertheless, the issuance of *sukuk* based on *murabahah* and *bay bithamanajil*(BBA) are considered as debts. In the Malaysian approach, Malaysian scholars have also applied the concept of *bai al-dayn* or the sale of debts. Consequently, this kind of *sukuk* can be traded in the secondary market. Several scholars criticized this type of *sukuk* and thought that *murabahah* and *BBA sukuk* open the door back to interest (Jalil, 2005). Therefore, this paper attempt to address several issues and challenges that had been discuss by the previous studies.

3. Issues and Challenges of *Sukuk*

The critical scholars argue that the contemporary practice of Islamic finance is directed towards replicating the practices of conventional finance and in doing so; contemporary Islamic financial products are Shariah-compliant in form but not in substance and spirit. They critic that the practice of *sukuk* simply replicating the practice of conventional bond in the market. Furthermore, the practice of *sukuk* has been lacking of transparency in respect of documentation and rights and liabilities of various parties in the *sukuk* market. This is a concern from the perspective of *shariah* compliance because *sukuk* that are sold to buyers and they are ignorant of the essential elements of the contract due to asymmetric information run the risk of violating the prohibition of *gharar.* For that reasons, more instruments are needed and existing products need to be refined as some *sukuk* structures are still debated and contested (Bashir, 2008). Economic value added and shariah compliance are at the heart of product development in *sukuk* market. It thus requires a process of shariah approval. Unfortunately, it seems that the existing mechanism of shariah scholars' involvement in product development, harmonization and approval may not be adequate enough for a rapidly growing market that needs to expand according to international standards of best practices and at the speed of market demand.

Ijarah sukuk was the first *sukuk* structured marketed in the global area. However, the *Ijarahsukuk* had been criticised by some shariah scholars. Study by Al-Amine, (2008) addressed several of the criticisms against the *Ijarah sukuk* structure in term of issue of guarantee, the mechanism of sale and lease back and whether it resembles *bay al wafa* or *bay al inah* that has been rejected by the majority of Muslim scholars, the purchase undertaking at a pre-determined price that representing the original or principal amount of the *sukuk* and finally the pricing mechanism of *sukuk* issuance which is generally tied to the London Inter Bank Offer Rate (LIBOR) and not to the actual rental of the asset underlying. Ahmed et al. (2014) stress that the pricing of *sukuk* that relies on usually benchmarked to the LIBOR on $US dollar funds is one of the main issues in *sukuk* and identified associating with *riba.* It also a controversial issue among the shariah scholars.

Study by Ellias & Mohammed (2013) point out that one of the main critics from the shariah scholars is the beneficial ownership in asset based *sukuk.* Since the *sukuk* represents its holders' ownership over certain underlying asset, some Shariah scholars and practitioners debated whether the ownership status of the *sukuk* holder is in accordance to shariah requirement. In most countries including Malaysia, the rationale that most *sukuk* is structured on asset-based rather than asset-backed due to the restriction on foreign ownership of certain assets. The *sukuk*-holders will only have security interest in the asset. This means the *sukuk*-holders are merely creditors and not owners of the asset**.** In case of foreclosure any surplus out of the asset disposal must be returned to the obligor. Compared to asset backed *sukuk*, the *sukuk* holder has full ownership of the asset. Thus, Dzubaidah Zainal Abidin & Shahida Shahimi, (2013) justify that, in the event of default, the asset based *sukuk* holder do not have any interest in the underlying asset and the ownership of the asset but only hold beneficial ownership of the asset.

Despite the controversial issues on asset based *sukuk*, the issuance of hybrid *sukuk* has increase attention among the shariah scholars. Prior to the 2008 AAOIFI Resolution, financial institutions were also permitted to issue negotiable hybrid *sukuk.* On the more liberal Hanafi's view, hybrid *sukuk* may be negotiable in certain cases even if the percentage of tangible assets is less than fifty-one percent. However, the 2008 AAOIFI Resolution ruled that in order to be negotiable, *sukuk* must not represent receivables or debts at all. Pursuant to that principle, at least fifty-one percent of the pool of assets must comprise of tangible assets such as *ijarah* for the hybrid *sukuk* to be negotiable.

Furthermore, Goldman Sachs (2011) mentioned in his studies, the issuance of *sukuk* consequently marred by controversy because it was arguably based on a reverse *tawarruq*, which has not received general acceptance from *Shariah* scholars. *Reverse tawaruq* is similar to the *organized tawaruq* and impermissible by the OIC Fiqh Academy in its resolution 2009. However, contemporary banks still persist in the usage of this structure for deposit, financing and *sukuk* issuance.

Challenges

The remarkable success of the *sukuk* market in Malaysia is largely due to the several positive factors and supported by Malaysia's government. However, instead of the increasing numbers of *sukuk* issuance in the global market, the *sukuk* market hindered by a number of challenges and constrains. First challenges are regulatory development. In the Gulf Cooperation Council (GCC) countries, the regulatory framework for securitization is not yet developed. One of the main legal challenges is the restriction on foreign ownership of certain assets in the GCC. The huge demand for finance and the growing popularity of *sukuk* as a mainstream asset class among fixed-income investors in Asia and the Gulf is pushing countries to establish or enhance their regulatory frameworks. Malaysia is working to cement its position at the head of the *sukuk* market by attracting global issuers and investors. Over many years, it has built up a strong Islamic debt capital market--alongside its conventional capital market-with well-defined regulation, standard *sukuk* structures, and a large pool of liquidity.

Second challenges, the small percentage of socially responsible investment (SRI) or green *sukuk* in the market compared to green bond. To date Green bonds, consider as a big business in the global market. Since 2007, the overall green bond market has been compound annual growth of 50%, and then in 2015 saw around US42 billion in conventional green bonds come to market according to Moody's Investor Services but in practice on the other hand, very few green *sukuk* were issued in the market. One of the big challenges for the issuance of a green *sukuk* is the market for such green instruments is still not mature (Lauren & Mcaughtry, 2016). At present, there is approximately USD65.9 billion worth of green bonds available in the market. As at 2014, Malaysia's Prime Minister in his Budget 2014 speech announced the aspiration of Malaysia to become a home for SRI. The prospect of green *sukuk* in the future encourages by the numbers of factors including investor awareness, government support, demand for energy financing and demand for energy supply (www.mifc.com.my).

Third challenge is the complexity of *sukuk* structure in the market. This complexity structure of *sukuk*is another impediment to the development of *sukuk* market (Micheal Bennet & Zamil Iqbar, 2012). The global financial crisis drew attention to the dangers of highly complex structured products. Specifically, such products are difficult to value as well as to unwind in the event of default. Many complex products are suffered significant downgrades and defaults during the financial crisis are also leader in the business of structuring *sukuk*. Hence the complexity of *sukuk* structures may continue to discourage participation from many investors and issuers who was burned before by structured products.

4. Conclusion

Malaysian *sukuk* market has shown remarkable progress since it first introduced in 1990 and Malaysia has successfully created a niche market in this area. It has been growing rapidly because of its attraction for users as well as because of the push by the central bank to create this new market as the major funding market of the world. Despite the encouraging growth and development of the *sukuk* market, it seems that there are many controversial issues that need prompt solutions in order to sustain the development of the *sukuk* market. To ensure the sustainability of *sukuk* in the future, all parties including regulator and shariah scholars must take a vast action to settle the several issues on *sukuk.*

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