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

Nor Fadilah Bahari
Nurul Wajhi Ahmad
Wan Shahdila Shah Shahar
Norfaizah Othman
Faculty of Management & Muamalah
Selangor International Islamic University College
Bandar Seri Putra, Bangi, Selangor, Malaysia
norfadilah@kuis.edu.my, nurulwajhi@kuis.edu.my,
shahdila@kuis.edu.my, norfaizah@kuis.edu.my

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

1. Introduction

The Development of Sukuk Market

The Islamic finance industry has witnessed significant developments and that includes sukuk market. In Malaysia, sukaks 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](image1.png)

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](image2.png)
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, it witnessed 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.

![Key Drivers of Sukuk Issuances](image)

**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 least 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.

![Exhibit 1: Classification of Sukuk](source)

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 sukuk 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, sukuk 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 criticized 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 US$42 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 (Michael 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.

References


