

GROWTH AND PROSPECT OF SUKUK IN MALAYSIAN MARKET: A REVIEW

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ABSTRACT

Sukuk or Islamic bond is one of the *Sharia*-compliant financial instruments in the Malaysian capital market. The growth of the Islamic bond market in Malaysia has shown an impressive development over the past three decades. In fact, *sukuk* grow internationally with a positive trend. This paper aims to provide insights into the growth and prospect of Islamic bond in Malaysia. For this purpose, we will emphasize on several areas including the growth of *sukuk*, roles in the economic development and its sustainability during financial crisis. Despite the rapid growth of other financial instruments, we expect the growth movements of Islamic bond to outpace as this instrument provides opportunities to beat a wider investor.

Keywords: *Sukuk*, growth, economic growth, financial system.

INTRODUCTION

Sukuk originated from an Arabic term; it is a plural of term *Sakk* which means certificate. *Sukuk* (plural of *sakk*) are referred to as 'Islamic bonds' but the correct translation of the Arabic word of *sukuk* is 'Islamic Investment Certificates'. Under *sukuk* structure, the *sukuk* holders (investors) each hold an undivided beneficial ownership in the "*Sukuk* assets". (Tahmoures, 2013). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) officially defined *sukuk* as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (AAOIFI, 2008). (Mosaid & Rachid Boutti, 2014).

According to Malaysia Debt Securities and *sukuk* Market sources, in 2011 *sukuk* may be defined as certificates of equal value that represent an undivided interest (proportional to the investor's interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services or investments in particular projects or special investment activities. Through this concept, *sukuk* enjoy the benefit of being backed by assets, thereby affording the *sukuk* holder or investor a level of protection which may not be available from conventional debt bonds. (Ahmed Essia Ries, Islam, 2014). Although a common starting point in differentiating both *sukuk* and conventional bond is to explain Shariah point of view, it is very important to ascertain the fundamental comparison between these two instruments. It is clearly understood that *sukuk* is adhered to Shariah principles and bond is definitely involving *riba* due to fixed interest in nature.

Table 1: Fundamental Differences between Sukuk and Bond

Sukuk	Bonds
<ul style="list-style-type: none"> ▪ Sukuk indicate ownership of an asset 	<ul style="list-style-type: none"> ▪ Bonds indicate a debt obligation.
<ul style="list-style-type: none"> ▪ The assets that back sukuk are compliant with Shariah 	<ul style="list-style-type: none"> ▪ The assets that back sukuk are compliant with Shariah
<ul style="list-style-type: none"> ▪ Sukuk are priced according to the value of the assets backing them 	<ul style="list-style-type: none"> ▪ Bond pricing is based on credit rating.
<ul style="list-style-type: none"> ▪ Sukuk can increase in value when the assets increase in value 	<ul style="list-style-type: none"> ▪ Profits from bonds correspond to fixed interest, making them Riba.
<ul style="list-style-type: none"> ▪ When you sell sukuk, you are selling ownership in the assets backing them 	<ul style="list-style-type: none"> ▪ The sale of bonds is the sale of debt.

Since conventional bond is prohibited in Islamic financial system due to interest-bearing and fixed income, sukuk were designed based on Shariah principles as an alternative instrument to all investors who are looking for a Shariah compliant instrument. In addition, sukuk were introduced for Islamic banks and financial institutions as a noble effort to move beyond *riba*. The security has become the most significant tools for raising capital in the domestic and international market. In 1990, the first RM125 million sukuk was structured by Bank Islam Malaysia Berhad and issued by Shell MDS, a foreign-owned company.

Back to 2002, world's first sovereign sukuk and global corporate sukuk was issued with RM600 million. Eventually in 2007, sukuk guidelines were issued under Capital Markets and Services Act 2007 by Securities Commission Malaysia. Indeed, sukuk are particularly interesting because the difficulties with sukuk arising from the world economic crisis resulted in notable governmental responses (I. Salah, 2010). Sukuk now has become the strongest segment in Islamic finance, are involved in the international market and generate significant cross-border flow of funds as may be achieved beyond domestic markets (Ahmed Essia Ries, Islam, 2014). There are two types of sukuk, asset based and asset backed.

Therefore, the purpose of this paper is to cultivate the awareness and knowledge base on the growth potential and future outlook, particularly in sukuk market as an integral part in Malaysia Islamic Finance sector. In addition, the discussion will also emphasize on the roles and importance of sukuk in serving the nation to meet global challenges. This paper consists of five sections. In the first section, this paper will highlight the growth of sukuk in Malaysia market; section two will concentrate on the importance roles of sukuk in the evolving economy; section three will then further explain on the sustainability of the sukuk instrument during economic commotion. Then the final section will conclude.

GROWTH OF SUKUK

Over the last decades, we can perceive the keen interest and attention in the Islamic finance industry on the international financial landscape. The growing demand on the instrument has created a flourishing Islamic financial system specifically in Malaysia. Sukuk market has grown previously in predominant Muslim countries, but now this instrument has been one of the significant discussions including in the world's leading conventional financial system. The sound economic development is relying on the capability of the capital market. Hence, it is important to note that the resilient capital market would eventually contribute to the rapid growth of the Islamic finance industry. Since 1996 until 2014, Malaysia has become the largest sukuk market which holds for nearly 67% of outstanding global sukuk. Indeed, the

Malaysian sukuk market is made up of 96% (USD \$431,65 bill) local currency issues & 4% (USD \$17.44) (Malaysia Islamic Finance Report 2015). In fact, in 2020, the government has set a target for Islamic banking asset to reach 40% of the total industry.

To date Malaysia has shown fast growth and the most active country in sukuk market but yet still has a lot of potentials as a viable Islamic financing alternatives instead of conventional bonds. Other countries that show the potential signs in developing sukuk are Indonesia, Pakistan, Singapore, Brunei Darussalam and Hong Kong. In fact, the Malaysian sukuk market has also grown to become more innovative and sophisticated to meet the diverse risk-return profiles and requirements of both issuers and investors (Zaid et al., 2011).

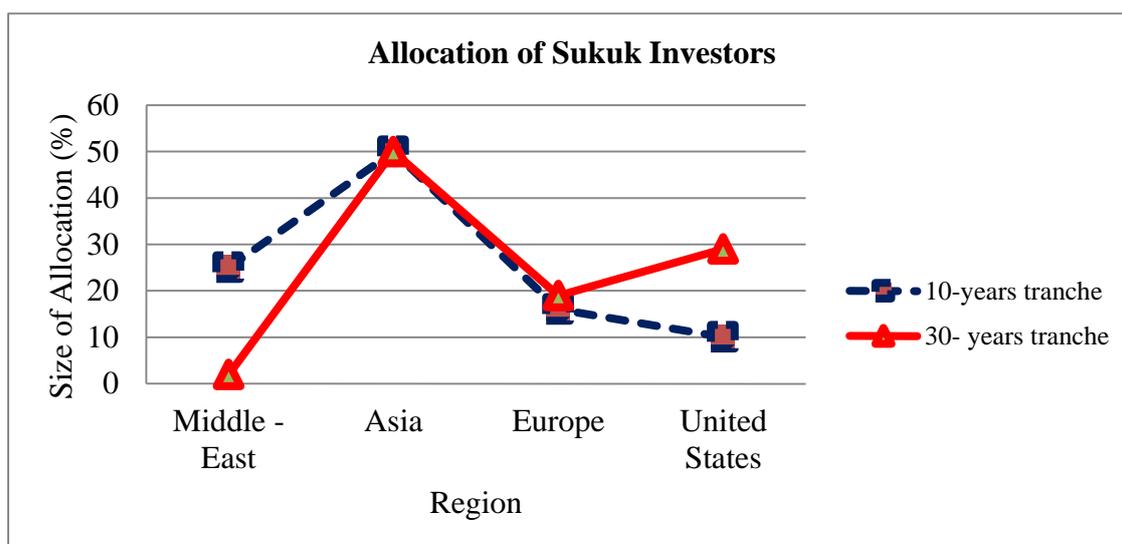


Figure 1: Allocation of Sukuk Investors

Ministry of Finance (MoF) in its media release stated that on 15 April 2015, the Government of Malaysia has successfully priced US\$1 billion of 10-year and US\$500 million of 30-year benchmark Trust Certificates (together, the “sukuk”), for a total deal size of US\$1.5 billion. As depicted in Figure 1, the 10- year tranche sukuk representing 50%, the highest allocation for Asia. A 25% contributed by Middle East countries, 16% and 10% was allocated to Europe and United States respectively. As for 30- year tranche, the longest inaugural sukuk offered and allocated also to Asia (50%), United States (29%), Europe (19%) and Middle East (2%). This deal is reflecting the strong confident of the investors and competitive Malaysian economy. Due to the significant growth of the market, sukuk issuance and trading have become important means of investment (O. Salah, 2013). After all, the main key factors drive the issuances of sukuk are:

1. Sustained global economic growth.
2. Sovereign liquidity needs (continued infrastructure spending).
3. Working capital and capex needs.
4. Attractiveness of cross-border destinations for fund raising.

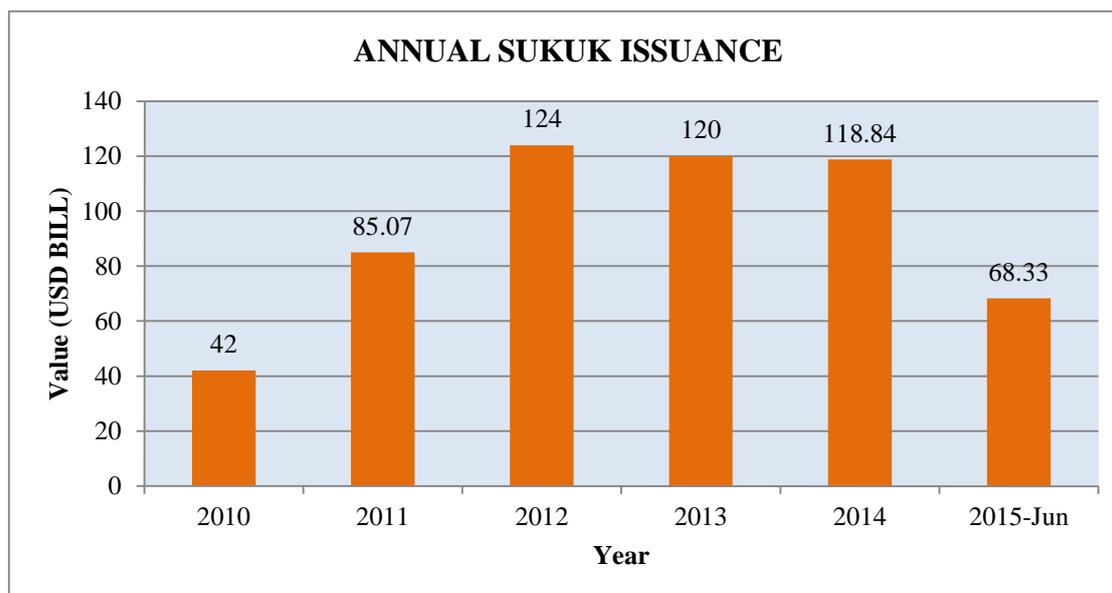


Figure 2: Annual Sukuk Issuance

Sources: Global Sukuk Report 1Q 2015, Business News

Based on Figure 2, size of sukuk issuance has shown tremendous growth during the period of 2010-2015. The growth was driven by both the key markets of Malaysia, Saudi Arabia and the United Arab Emirates (UAE), as well as emerging frontiers such as Turkey and Indonesia. More recently in 2014, landmark issuances were recorded from the UK, Hong Kong, Senegal, South Africa and Luxembourg – cementing the sukuk market’s status as a viable and competitive source of funding (Global Sukuk Report 1Q 2015).

Sukuk issuance in 2015 up to June, has witnessed a dropped in the sukuk issuance due to the pull-back decision by Central Bank of Malaysia (BNM) and switched to other liquidity management instrument. The reason behind the BNM decision is due to the impact of fuel prices, political commotion and drop in value of MYR. Furthermore, sukuk issuances for 2016 are also remains uncertain due to the effect of fuel prices and the industry performance will definitely depend on the economic recovery and government spending.

Figure 3 depicted the issuance of Sukuk for the first quarter in 2015 by most countries. No doubt, Malaysia has lead with the total sukuk issuance of 42.3%, followed by United Arab Emirates (UAE) with 18.2%. According to I. Salah, 2010, most sukuk offerings take place in the Gulf Cooperation Countries (GCC) and Malaysia, with a significant number of offerings being undertaken by sovereigns or state enterprises (I. Salah, 2010). A newcomer to the sukuk market is Central Bank of Bangladesh, which began issuing short-term sukuk for liquidity management purpose, showing a positive pace in the Islamic finance industry as a whole.

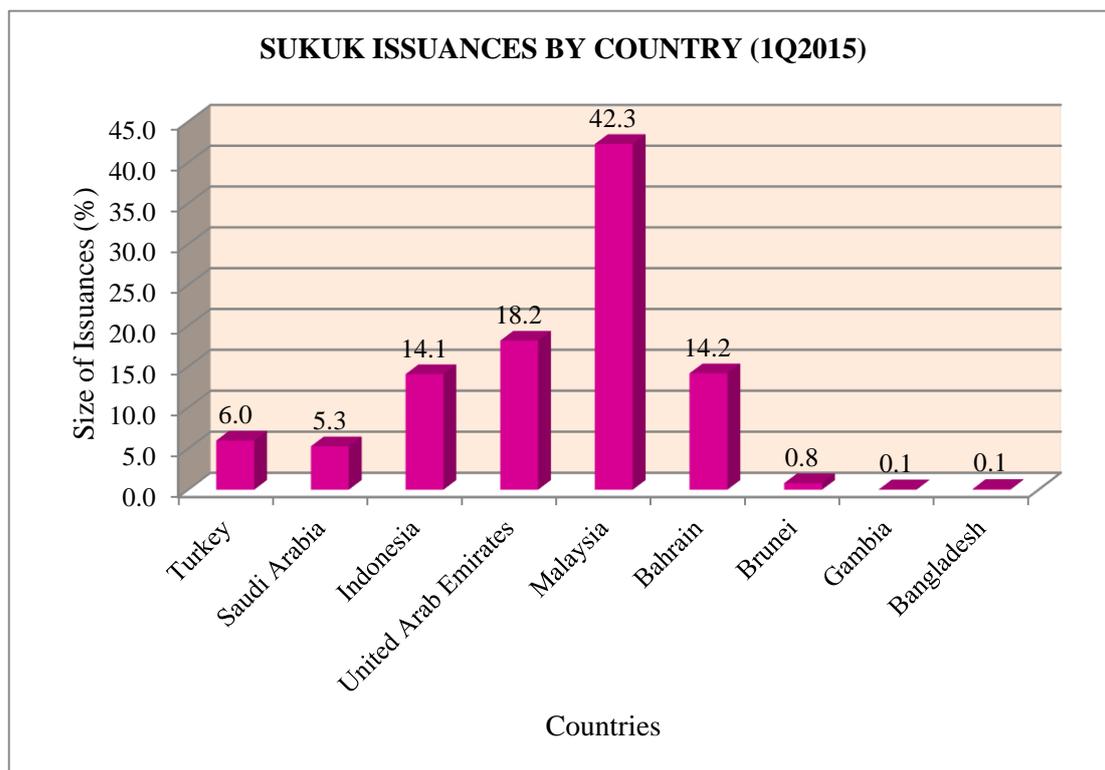


Figure 3: Size of Sukuk Issuances by Country
Sources: Global Sukuk Report 1Q 2015

SUKUK AND ECONOMIC DEVELOPMENT

Sukuk has proven its functions as an important part of the global economic in ensuring and promoting financial stability. An emerging of this instrument has finally changed the financial landscape. In fact, the first sukuk al-Ijarah was issued by government in July 2002 which based on property asset traded in the international market. Its purpose was to expand the nation's Islamic financial instrument and to generate the liberalization of Islamic capital market (Yahya, Hussin, & Muhammad, 2012). Another essential function of sukuk is by providing capital and liquidity to the demanders of fund in the overall financial system. In fact, the notable trend in 2013 to 2014 were the issuances of sukuk which to support Islamic financial institutions' compliance with Basel III liquidity and capital requirements (Global Sukuk Report 1Q 2015, 2015). Besides that, sukuk also promote the development of capital market by allowing small capitalized investor or market players to actively participate in the market. On the corporate side, sukuk plays an important role as a source of financing for large scale project and investment managed by corporations. In terms of investment diversification, this long term security provides another new asset classes to accommodate investors' preferences.

Sukuk plays an important role in financing the economy accounting for more than half of the country's total debt, both in terms of balance outstanding and issuance (Haron & Ibrahim, 2012). Sukuk became exist as the essential means in Islamic finance industry in order to obtain a return on liquid reserves. In addition, this instrument can foster the development of capital markets by allowing thinly capitalized market players who may have specialization in securitization and issuance to participate in the capital market (Ali, 2005).

On the other hand, sukuk also play an important role in agriculture activities in Yogyakarta Province, Indonesia. Soeleman & Dwi (2015), has conducted a research on the implementation of sukuk financing in five different regencies namely Kulon Progo, Bantul, GunungKidul, Sleman, and Kodya Yogyakarta. The main aim of their research is to ensure the profit gained from agricultural activities will be shared based on the pre- agreed ratio (PSR) between the investors and the people involved. Ultimately, the result shown that all skilled-worker, farmers, and land-owners receive better compensation if they are treated based on sukuk-based profit sharing instead of fully- paid salaries and rental (Soeleman & Dwi, 2015).

Sustainability of Sukuk

The world witnessed the strong potential and growth of sukuk in recent years. For the first quarter of 2015, the sukuk market has touched new elevations over the past few years. It covered more issuer, more cross-border activity and more innovative issuance. However, the sukuk market did not do well when the recent subprime crisis in the United States erupted. It resulted in global sukuk issuance declining by more than 50% by the end of 2008 (Wahida & Rafisah, 2011). This is due to credit crunch, which forced investors to step aside from the fixed income market, including the Islamic model. As evidenced by the recent subprime financial crisis of 2007-2008, sukuk are susceptible to deterioration. However, it is important to note that the effect is considered to be less severe compared to the conventional bond market (Wahida & Rafisah, 2011). However, according to Alam, Hassan & Haque (2013), the cumulative return for Sukuk issue after crisis period is positive and significant at 5% which confirms wealth creation for the shareholders of firm offering sukuk. This finding validates the results of Mikkelson and Partch (1986), which states that certain types of debts instruments can lead to abnormal return.

Ali Said & Rihab Grassa (2013) found that, the financial crisis has a significant negative effect on the development of the sukuk market since the amount of sukuk issued in those years has declined considerably. However, the Dubai debt crisis has no significant effect on the development of sukuk market. Furthermore, bond market has a significant and positive impact on the development of sukuk market. Thus, it appears that conventional bond market and sukuk market are complements rather than substitutes. This study was conducted using Panel Data Analysis (2003-2015) with a maximum of 100 years' observations. Ten countries were selected, which are Saudi Arabia, Kuwait, UAE, Bahrain, Qatar, Indonesia, Malaysia, Brunei, Pakistan, and Gambia.

On another finding, A. Said (2011) revealed that there were weaknesses in strength, deployment, efficiency, and profitability for these banks during a financial crisis during 2008 as compared to 2007. This research emphasized on the impact of using sukuk on Islamic banks performances. He found that the uses of regression analysis that sukuk has not impacted the performance of Islamic banks. Additionally, the study showed that Islamic banks increase the using of this financial tool, sukuk, to provide liquidity and mobility for bank resources. There are two factors that need prompt solutions in order to sustain the development of the sukuk structure and sukuk market. This requires a close cooperation among Shariah scholars and financial experts on one hand, with this, it is hoped that the Islamic sukuk will become more comprehensive in its Shariah compliance and thereby bring more credibility to the Islamic financial system in general (Ahmed Essia Ries, Islam, 2014).

FUTURE OUTLOOK OF SUKUK

No doubt, sukuk proved that it is among the most successful Islamic financial instrument in the industry and be one of the fastest-growing sectors in the global financial landscape. To date, sukuk growth remain intact with a slightly increase from 3.4% in 2014 to 3.5% in 2015 supported by lower inflation rate, accommodative monetary conditions and sustained growth in global trade (Global Sukuk Report 1Q 2015, 2015). Since Malaysian currency has declined to its lowest level in more than five years and the country's financial health is flagging, it doesn't pay for Malaysia to issue dollar sukuk now. In fact, in the first half of 2015, the Central Bank of Malaysia's shrinks away 42.5% the total sukuk issuance. (S&P Global Head of Islamic Finance Mohamed Damak).

However, if all drivers remain intact and gain full support from the authorities, sukuk market will likely to pick up for the next quarter. Furthermore, sukuk has a very good potential to be a source of funding for long- term project. Indeed, under 2016 Budget, Government has put a good initiative to further strengthen the sukuk (Ijarah & wakalah) market by extending tax deduction 2016-2018 under the requirements of Sustainable and Responsible Investment (SRI). Moving forward, Malaysia will continue its determinations to further strengthen sukuk momentum via cross boarder linkages, cooperation and collaborative partnership in order to contribute more to the overall financial industry and economic development. Better collaboration, governance, legal and regulatory will definitely expedite the issuance of sukuk instrument.

CONCLUSION

To ensure the continuous financial stability, both Shariah scholars and the financial experts must collaborate in order to reach a broad and bring more credibility to the Islamic financial institutions and corporation as well. Various factors are likely to influence the development of sukuk in the Islamic finance industry namely political commotion, financial crisis, macroeconomic factors (economic size, GDP) and regulatory quality. Thus, the experts should focus on how to overcome these obstacles, mitigating of risk in these arduous times and make sukuk be more acceptable in the international market which comprises of various economic landscapes. This will ultimately assist the authorities to foster the growth of the sukuk market. In fact, we still have opportunity to outpace the global market before the United States (US) raised its interest rate.

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