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DO SUKUK FINANCIAL INSTRUMENTS MIRROR CONVENTIONAL BONDS?

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Abstract

Growth in both Islamic finance literature and sukuk issuance in the Islamic capital market over the last decade has led to the question of whether sukuk are variants of conventional bonds or they differ. In order to provide an answer to the question, this study reviews extant literature to extract similarities and differences between the two debt instruments. The review shows that although sukuk are Islamic debt financial instruments that confer part-ownership of the underlying assets on their holders, conventional corporate finance theories are also applicable to sukuk. Consequently, the paper concludes that for policy makers and researchers to make a clear distinction between the two debt instruments, there is need to expand sukuk research to cover areas such as risk-shifting and risk sharing. Additionally, sharia based pricing benchmark for sukuk may be adopted.

Keywords: Bonds; Debt; Islamic Capital Market; Sukuk,

1.0 INTRODUCTION

A fundamental function of the capital market is to provide medium to long-term funds to finance capital-intensive projects. In order to attract funds into the market to carry out this important function, innovative financial products that meet specific needs of investors and fund-seekers are introduced into the market (Alam, Hassan, & Haque, 2013; Etudaiye-Muhtar, Bashir, & Abdulkadir, 2012). The Islamic capital market serves as an alternative to the conventional capital market where corporate and sovereign entities seek access to long-term funds (Kusuma & Silva, 2014). One such product in the Islamic capital market that enables the market to fulfil this function is the Sukuk financial debt instrument. Sukuk are faith-based debt instruments that cater to the needs of the Islamic faith with its operation being guided by Islamic law principles (*Shariah*). These principles include prohibition of *Riba* (interest), *Maysir* (gambling or speculation) and *Gharar* (uncertainty).

Nevertheless, Kusuma and Silva (2014) note that sukuk serves as an avenue to access funds from a new investor base consisting of individual and institutional investors in Islamic financial markets. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Shari'a standard No. 17 defines Sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services (in the ownership of) the assets of particular projects or special investment activities." Likewise, Nathif and Thomas (2004) define it as a claim that is similar to a note or certificate representing ownership to an asset or a pool of assets as against a financial claim to a cash flow or receivables in a conventional bond. Inferring from these definitions, sukuk may not be taken as claims of debt in monetary terms because of the non-tradability of money under sharia law. This serves as the foundation of the prohibition of interest-bearing debts in Islamic finance (Kusuma & Silva, 2014).

Financial transactions conducted in Islamic capital markets all over the globe has grown from relatively small-sized transactions to large-sized ones. The driving force of this growth may be traced to the issuance of Sukuk financial debt instruments by both sovereign and corporate entities (Alam et

al., 2013). For instance, the International Islamic Financial Market (IIFM) financial report of 2014 reports that global Sukuk issuance grew from \$1,172 billion in January 2001 to 68,197 billion as at July 2014. The total value of Sukuk issued over the same period was reported as \$668,058 billion. Similarly, Kusuma and Silva (2014) reports the size of worldwide Islamic Sharia financial assets as \$1.8 trillion as at 2014. These assets consist of banking assets, sukuk and other funds with sukuk representing 15% of the total value.

Notwithstanding the growth in Sukuk financial transactions, several authors have questioned whether Sukuk is another variation of the conventional bond (Afshar, 2013; Alam et al., 2013; Ariff, Safari, & Mohamed, 2013; Godlewski, Turk-Ariss, & Weill, 2011; Hassan, 2012). The question arises due to similarities observed in the two debt instruments although different approaches are used in examining the similarities / differences between them. Table 1 adopted from Hasan and Hamza (2013), highlights the main differences between sukuk and conventional bonds.

Table 1: Major Differences between Sukuk and Conventional Bonds

	Sukuk	Conventional Bond
1	Each Sukuk unit represents an ownership of the underlying asset	Bonds represent pure debt obligations due from the issuer
2	Maturity of the Sukuk corresponds to the term of the underlying project or activity	The core relationship is a loan of money, which implies a contract whose subject is purely earning money on money
3	The Sukuk prospectus contains all the Shariah rules related to the issue	The issue prospectus does not include Shariah constraints
4	The underlying asset / project / business has to be Shariah complaint (i.e. not dealing with pork related items, gambling, tobacco, institutions that deal with Riba (interest))	The underlying asset / project / business can belong to any sector / industry
5	The Sukuk manager is required to abide by Shariah rules	Can be issued to finance almost any purpose which is legal in its jurisdiction

Source: Hasan and Hamza (2013)

This paper reviews existing literature to further highlight areas of similarities and differences between sukuk and conventional bonds in order to provide an answer to the question of whether sukuk is not different from conventional bonds. Section 2 of this paper reviews existing research to answer the question posed in the title while Section 3 draws a conclusion based on the literature review.

2.0 DO SUKUK MIRROR CONVENTIONAL BONDS?

As noted in the introductory part of this paper, the question of sukuk mirroring conventional bonds arises due to similarities observed in the two debt instruments. A fundamental difference observed in Table 1 between sukuk and bonds is the asset ownership structure. While sukuk holders are owners of part of the underlying assets of a transaction and therefore confer ownership, conventional bonds are debt obligations evidencing the existence of debt that are issued to bondholders (Alam et al., 2013; Jamaldeen, 2012). This as suggested by Alam et al. (2013) and Jamaldeen (2012) implies that sukuk signifies part ownership in project, business or joint venture while bonds signifies shares in the overall debt. A salient point here is that under sukuk structures, investors share risk with the businesses they finance (Wijnbergen & Zaheer, 2013).

Differences between Sukuk and conventional bonds in Islamic finance empirical literature are usually examined in terms of issuance structure, regulatory / legal requirements, diversification / alternative investment opportunities and effect on returns. For example, while some studies such as Godlewski et al. (2011) and Cakir and Raei (2007) show that sukuk are alternative investment

outlets, Ariff et al. (2013) and Fathurahman and Fitriati (2013) show that sukuk have significantly higher risks than conventional bonds hence higher returns. Nonetheless, Alam et al. (2013) report a negative relationship between sukuk issuance and returns.

Arguing for the similarity between the two debts instruments, Nagano (2016) contends that sukuk issuance follows conventional corporate finance theory. This was observed in the reduction of information gathering costs between issuers and investors following an increase in the number of sukuk issuers due to sukuk market development. Likewise, Mohamed, Masih, and Bacha (2015) utilising a partial adjustment model of debt, conclude that sukuk issuance follow conventional corporate finance theory. Specifically, the authors argue that sukuk issuance follow the trade-off theory through optimization of firm behaviour. They equally observed support for the pecking order theory of capital structure in some partnership based sukuk when firms are faced with higher costs arising from information asymmetry. Further evidence supporting the assertion that sukuk follows corporate finance theory is observed in Klein and Weill (2016) and Godlewski, Turk-Ariss, and Weill (2013) where information asymmetries via moral hazard and adverse selection were found to enhance firms' choice of issuing sukuk.

Other empirical research highlighting similarities between sukuk and conventional bonds include execution of contracts under Sukuk which are structured after conventional bonds (Cakir & Raei, 2007) and Sukuk returns mirroring conventional bond returns (Miller, Challoner, & Atta, 2007).

In terms of issuance and regulatory structure, Zulkhibri (2015) argues that in order to integrate Islamic finance into the global financial market and harness advantages of sukuk issuance, there is need for sharia compliant transactions in secular Western economies. The integration may be achieved by incorporating sharia law into the laws of the country concerned such that Sharia law governs Islamic financial transactions. This clearly marks another major difference as observed in Table 1 since the laws applicable in a secular country already covers bondholders. Zulkhibri (2015) further notes that the existence of sound accounting and reporting standards ensures a well-regulated Islamic financial system. This is of particular importance since the main essence of Islamic finance is to ensure equity and fairness in financial transactions (*Maqasid al-Shari'ah*). Nonetheless, the problem of sukuk default was traced to sukuk structures mirroring conventional bond structures especially in terms of mismatching relevant jurisdictions, ill-defined property rights and choice of legal rights (Majid, Shahimi, & Abdullah, 2010; Wijnbergen & Zaheer, 2013; Zulkhibri, 2015).

Empirical literature also suggests that macroeconomic factors have influence on sukuk market development as obtained in the conventional bond market. For example, gross domestic product per capita, population and trade-openness in Said and Grassa (2013) were observed to have significant and positive economic impact on sukuk market development similar to the conventional bond market. Nonetheless, the bond market in the same study was also noted to have a positive effect on sukuk market development suggesting that the two financial debt instruments (conventional bonds and sukuk) complement each other and are not substitutes of one another. In a similar study, Ahmad, Daud, and Kefelia (2012) employing series of econometric techniques, found that a country's business cycle, inflation rate and gross domestic product are all important determinants of sukuk market development. Specifically, sukuk was found to Granger cause gross domestic product while gross domestic product Granger-causes both business cycle and inflation while noting that in the short-run, the sukuk market is driven by its own dynamics.

3.0 CONCLUSION

The growth in Islamic finance capital market and literature has led to the question as to whether sukuk are variants of conventional bonds or are different financial debt instruments. This paper reviewed existing literature to answer the related question along the lines of empirical research, macroeconomics, regulatory and legal requirements. We found that existing research portends that similarities exist between the two debt instruments and so do differences. The similarities as

explained by literature may be due to sukuk being issued along conventional bond structures. Furthermore, research on macroeconomic determinants of both debt instruments suggests that the determinants are similar. In addition, literature established that corporate finance theory might be applied to sukuk structures especially in terms of theories relating to information asymmetries, pecking order and optimization of firm behaviour. Nonetheless, we observed that the main difference between the two debt instruments is the faith-based application of sukuk where it has to be shariah compliant and follow shariah law. Additionally, sukuk may be described as an equity based ownership financing instrument that confers part-ownership on the investor unlike conventional debt instruments that only serve as evidence of debt obligations.

Inferring from the preceding paragraph, we suggest that further investigations are required to enable researchers and policy makers differentiate wholly, the distinction between the two. One of such investigation is to apply advanced corporate finance research methods that are applied to conventional bonds, to sukuk financial instruments. One of such method would be investigating risk-shifting and risk-sharing behaviour in sukuk instruments. Furthermore, there is need to have sukuk structures issued strictly in accordance with Islamic finance law and not structured to follow conventional bonds. For instance, alternative pricing structure for sukuk instruments based on sharia principles may be explored instead of linking it to the London Interbank Offered Rate (LIBOR), an interest based benchmark rate.

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