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Understanding Sukuk Market Development: An Overview of Opportunities and Challenges

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Abstract: Sukuk, as integral Islamic financial instruments, have witnessed substantial growth in recent years, signifying a significant evolution in the Islamic finance domain. This paper delves deeply into the dynamics surrounding the development of the sukuk market, meticulously examining both the opportunities it presents and the challenges it poses. In this study, a qualitative research methodology is employed, consisting of two main approaches: exploration and descriptive analysis. Through an exploratory study and descriptive analysis, data were gathered primarily from online libraries and databases. Through a meticulous synthesis of existing literature and empirical evidence, this research endeavors to furnish a comprehensive understanding of the myriad factors influencing the growth of the sukuk market and the implications for diverse stakeholders involved. By shedding light on the potential of sukuk as a viable investment avenue, while concurrently addressing the regulatory, structural, and market-related obstacles impeding its broader adoption and expansion, this study aims to offer valuable insights.

Keywords: Sukuk; Sukuk Market Development; Sukuk Market Challenges.

Introduction

Over the past decade, Islamic finance has witnessed substantial growth (Hussain et al., 2016), evident in various sectors such as sharia banking, sukuk, sharia stock indexes, and exchange-traded funds (Nasr et al., 2016; Raza & Ashraf, 2019). In 2021, the Islamic capital market industry reported significant expansion, constituting 30.5% of global Islamic Financial Services Industry (IFSI) assets, equivalent to USD 930.3 billion. The issuance of state and multilateral sukuk played a pivotal role in this growth, supporting fiscal funding and environmentally sustainable projects (Islamic Financial Services Board, 2022). The escalating prominence of sukuk in the Islamic capital market, driven by rapid growth, positions it as an evolving instrument for capital mobilization (Lahsasna et al., 2018a).

The sukuk market's rapid growth has surpassed that of Islamic banking, as evidenced by the International Islamic Financial Market (IIFM) Sukuk Report 2021, showing a 7.72% growth (USD 188.12 billion) in 2021. This expansion is propelled by global economic stimulus measures, prompted by inflationary pressures and rising commodity prices, especially in the oil sector (International Islamic Financial Market, 2021). Sukuk, being the second-largest subsector of Islamic loans, has extended its influence globally, encompassing both Muslim and non-Muslim countries alike (Hassan et al., 2022; Zulkhibri, 2015).

Sukuk, characterized as certificates representing ownership stakes in underlying assets, have emerged as crucial instruments in the Islamic capital market (Ahmed et al., 2015; Lahsasna et al., 2018b). Derived from the Arabic term "sakk," meaning a legal document or certificate, sukuk offer an alternative to conventional interest-based economies, particularly poignant considering vulnerabilities exposed by the 2008 global financial crisis (Fadel, 2008; Feroz, 2009). Extensive research has examined sukuk market dynamics, presenting them as viable avenues for capital procurement and fostering sustainable economic growth (Azhgaliyeva et al., 2020; Paltrinieri et al., 2023). Sukuk not only mitigate risks but also contributes to social equity by reducing governments' reliance on domestic and foreign bank loans through debt reduction (Ismath Bacha & Mirakhor, 2018; Mohamed et al., 2017).

Despite its growth and potential, the sukuk market faces several challenges that impede its full realization. Issues such as standardization of sukuk structures, regulatory harmonization, liquidity constraints, and investor perception are critically assessed to delineate the key challenges confronting the sukuk market. Ulusoy and Ela (2018) provides a comprehensive analysis of the challenges faced by the sukuk sector. They highlight the lack of consistency in sukuk documentation and the interpretation of Sharia principles, resulting in (i) a limited secondary market for sukuk, (ii) ambiguity within the sukuk market, and (iii) increased issuance costs. Consequently, they emphasize the importance of establishing a unified global Sharia council. Additionally, Rahman et al. (2020) demonstrated that the primary obstacles hindering the expansion of sukuk include investment risk, absence of standardized performance metrics, elevated transaction expenses, uncertain returns, insufficient availability of Sharia-compliant bonds, investor confidence, and knowledge gaps.

Therefore, this paper aims to bridge the existing knowledge gap by providing a comprehensive overview of the development of the sukuk market, focusing on its opportunities and challenges. Drawing upon a thorough review of existing literature, this study synthesizes findings from various studies to offer insights into the structural, financial, institutional, and macroeconomic factors influencing sukuk market growth.

Research Method

In this study, a qualitative research methodology is employed, consisting of two main approaches: exploration and descriptive analysis. Through an exploratory study and descriptive analysis, data were gathered primarily from online libraries and databases. Both primary and secondary data sources, including regulatory guidelines, articles, websites, and textbooks, were examined to offer a comprehensive understanding of the sukuk market's development, focusing on its opportunities and challenges.

Result and Discussion

Evolution of Sukuk Market

Sukuk, a financial product within the Sharia capital market, has emerged as a groundbreaking investment vehicle adhering to Sharia principles, as noted by Alswaidan (2013). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2013) defines sukuk as certificates representing proportionate ownership in physical assets, outcomes, or project and investment activities. In contrast, conventional bonds represent financial obligations where the issuer is indebted to the bondholder. Sukuk, serving as evidence of the investor's ownership, enable sharing in associated profits, as highlighted by Latham and Watkins (2015). This distinction is widely acknowledged in literature, including works by Godlewski et al. (2016), Asutay and Hakim (2018), and Hassan et al. (2018).

The Islamic Financial Services Board (2009) defines sukuk as certificates representing ownership interests in tangible assets or business ventures compliant with Sharia rules and principles, distinguishing them from conventional bonds. Sukuk, being asset-based and non-debt instruments, complies with Sharia principles, prohibiting interest-bearing debt transactions (Jalil, 2005). Therefore, sukuk issuance requires permissible assets or transactions, and their risk-return characteristics may resemble those of bonds or debt instruments, as discussed by (Kusuma & Silva, 2014).

Today, sukuk may not be preferred over interest-based securities, reflecting the objective of creating Sharia-compliant financial instruments distinct from Western debt securities with fixed interest rates (Wilson, 2008). Sukuk, rooted in asset ownership rather than debt, offers a hybrid characteristic akin to both bonds and shares, providing stable dividends or yields while reflecting ownership aspects (Iqbal & Mirakhor, 2008). The sukuk structure, foundational to Sharia-compliant securitization, underscores ownership of underlying assets (Maghyereh & Awartani, 2016).

Types of Sukuk identified by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2013) encompass various contractual arrangements, with Ijarah Sukuk being prevalent. It involves sale and leaseback transactions, allowing sukuk holders to own assets leased to obligors, typically used for project finance (AAOIFI, 2013). Murabahah Sukuk involves commodity purchase agreements, while Musyarakah Sukuk entails profit-sharing arrangements among multiple parties pooling resources for projects or business activities. Salam, Istishna', Wakalah, Muzara'ah, and Musaqah Sukuk represent other contractual arrangements with specific purposes (AAOIFI, 2013).

Regarding the debate over sukuk versus conventional bonds, sukuk's adherence to Sharia principles differentiates them. Sukuk lack fixed interest rates, prohibit certain transactions, and derive returns from underlying Sharia-compliant investments, diverging from conventional bonds' interest-based nature (Aloui et al., 2015; Bouslama & Lahrichi, 2017). Sukuk issuance establishes an ownership structure, sharing asset ownership and management among parties, with bondholders receiving a share of profits instead of interest (Maiga, 2021; Smaoui & Khawaja, 2017).

Functionally similar, sukuk and bonds operate on different principles, with sukuk serving as Sharia-compliant alternatives devoid of interest (Ahroum & Achchab, 2017). Sukuk offers reduced risks and cost-effective financing options, with returns influenced by various factors, including underlying contracts and asset ownership (Nasir & Farooq, 2017; Rafay et al., 2017). Compliance with Sharia law mandates sukuk trading to convey asset ownership rather than debt exchange (Elsheikh & Tanega, 2011), showcasing their distinctive nature compared to conventional bonds. Maghyereh and Awartani (2016) analyze sukuk and conventional bonds, highlighting differences in return rates and equity volatility effects.

Opportunities in Sukuk Market Development

The recent expansion of the sukuk market is truly remarkable. Among all Islamic financial services, the sukuk market stands out as the fastest growing. Sukuk, a popular capital market instrument utilized by governments, quasi-sovereign entities, financial institutions, and corporations, is frequently employed for project financing and infrastructure development (Khansari et al., 2015).

Global economic uncertainty has contributed to the growth of the sukuk market. Balli et al. (2020) demonstrated in their study the impact of economic policy uncertainty and macroeconomic news from the United States and the European Union on bond and stock markets. Unlike conventional bond markets, sukuk markets are less sensitive to global macroeconomic pronouncements and policy uncertainty.

The recent COVID-19 pandemic has raised significant concerns for global financial markets. In times of economic turbulence, investors seek secure investment channels to safeguard their capital. Sukuk, with its asset-backed and risk-sharing nature, emerges as an ideal choice for such goals. Moreover, its adherence to ethical principles prohibiting interest-based transactions and speculation presents a compelling alternative to conventional financial instruments. The appeal of sukuk as a safe-haven asset increases amidst economic uncertainty (Yarovaya et al., 2020).

Global sukuk outstanding surged from 76.730 USD billion in 2018 to 101.473 USD billion, as depicted in Figure 1. During crises, Islamic equity indices serve to hedge and diversify, supporting this assertion (Ashraf et al., 2020). Erdogan et al. (2020) conducted a study on COVID-19's impact on traditional and Islamic dividends in Turkey, revealing that Islamic equity indices exhibit lower volatility during viral outbreaks.

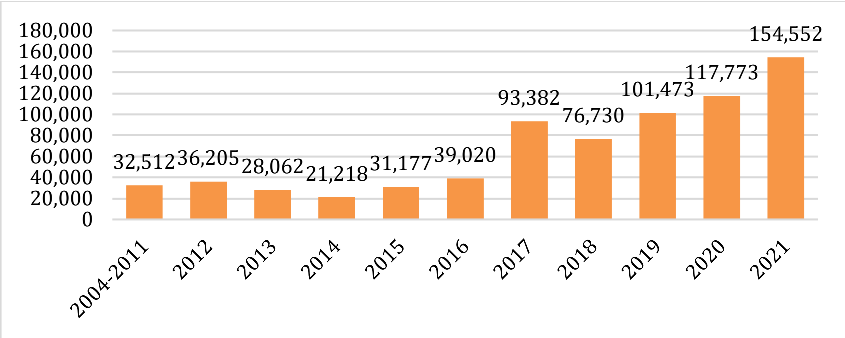

Figure 1 Total Global Sukuk Outstanding (2004-2021) in USD Billion
Source: IIFM Sukuk Report, 2022

The global circulation of sukuk reached USD 154.552 billion in 2021, marking a 23.7% increase from the previous year's figure of USD 117.773 billion (Figure 1). Sukuk are recognized as a practical means of raising funds for various purposes, including meeting the financial needs of enterprises and financial institutions, ensuring adequate capital, financing projects, fulfilling state budgetary and fiscal obligations, and managing liquidity, among others (International Islamic Financial Market (IIFM), 2022).

In 2021, the global sukuk market achieved a historic milestone with a record number of new issuances. Additionally, the growth rate of long-term issuances slightly outpaced that of short-term ones. Despite a 4.50% decrease in short-term sukuk issuance compared to the previous year, the short-term market remained stable in 2021, with various jurisdictions across the Far East, GCC, Africa, Asia, IILM, Turkey, Bangladesh, and other regions contributing to stability by issuing short-term sukuk. The total short-term sukuk issuance for 2021 amounted to USD 54.172 billion, down from USD 56.741 billion in 2020. Financial institutions issue these securities to facilitate liquidity management or meet investment requirements (IIFM, 2022).

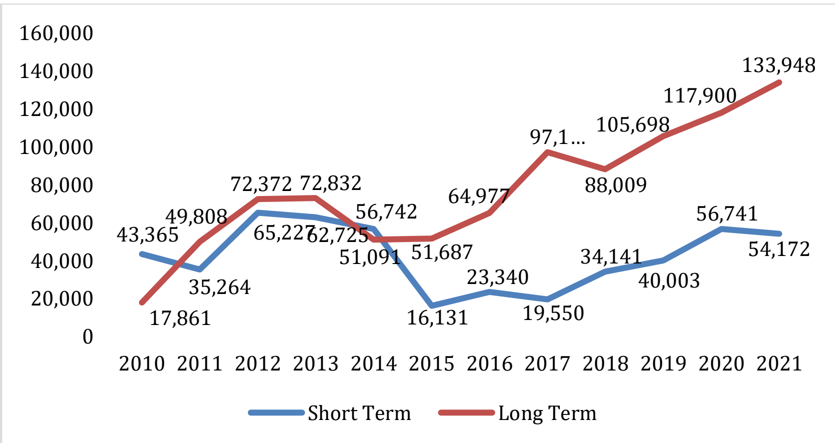

Figure 2 Total Global Long-Term Vs Short-Term Sukuk Issuances (Jan 2010 - Dec 2021) - All Tenors, All Currencies in USD Millions
Source: IIFM Sukuk Report, 2022

On the other hand, long-term issuance experienced significant annual growth, with a growth rate of 13.61%. In 2021, long-term sukuk issuance reached USD 133.948 billion, surpassing the 2020 issuance of USD 117.900 billion.

From January 2001 to December 2021, Asia consistently maintained its position as the leading participant in the global sukuk market, accounting for 66.95% of the global total issuance. The GCC and Middle East regions followed with a 25.95% market share, remaining significant driving forces in the sukuk market (Figure 3).

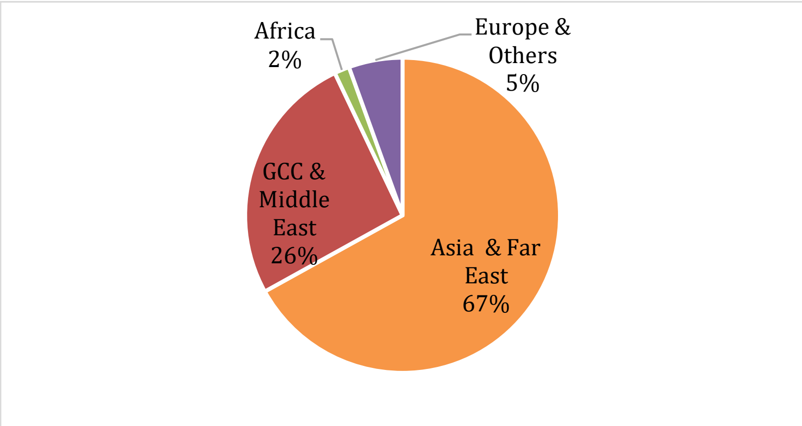

Figure 3. Regional Break-Up of Global Sukuk Issuances (Jan 2001 – Dec 2021) in % of Total Value
Source: IIFM Sukuk Report, 2022

Numerous studies have delved into the determinants of the Sukuk market over the past decade. Smaoui and Khawaja (2017) examined the structural, financial, developmental, institutional, and macroeconomic factors influencing the growth of the Sukuk market. Their findings highlight the significant impact of various structural, financial, and institutional factors on the Sukuk market.

Nagano (2016) explored the differences between Sukuk issuers and issuers of traditional debt and equity. The research indicates that the ease of access to the Sukuk market is a crucial factor in Sukuk issuance decisions. Additionally, corporations with fewer financial constraints are more inclined to issue Sukuk, and undervaluation of a company's worth before Sukuk issuance serves as an incentive. The study concludes that Sukuk issuance is more advantageous than market timing when market accessibility and pecking-order requirements are met.

Challenges in Sukuk Market Development

Sukuk, as a Sharia-compliant financial instrument, has emerged as a remarkable phenomenon since its inception, showcasing extraordinary growth. The progress and performance of Sukuk in recent years have been highly encouraging for various countries. Even so, it faces various obstacles that could hinder its future progress. In 2016, Naifar and Hammoudeh (2016) utilized quantile regression analysis to investigate how GCC Sukuk yields evolve over time and their relationship with global financial crises and other uncertainties. Their empirical evidence suggests that factors like oil prices, economic policy, and global financial uncertainty negatively affect GCC Sukuk returns, particularly in bearish market conditions.

Oseni (2014) highlights the absence of clear legal guidelines for default mechanisms as a complex issue hindering the global Sukuk trade, leading to subpar transactions. Discussions around Sukuk matters frequently involve topics such as restructuring strategies, legal frameworks, asset valuation processes, and the order of priority between Sukuk holders and creditors.

Another challenge is related to taxation issues. Taxation poses another significant challenge for the sukuk industry. Particularly in non-Muslim countries, the lack of clear taxation regulations hampers the growth of the sukuk market. Taxation, defined as a compulsory contribution to state revenue levied by the government on individuals' income, business profits, or added to the costs of goods, services, and transactions, presents complexities for the sukuk industry (Simpson & Weiner, 1993). Unlike traditional bond interest payments, sukuk operate within a distinct framework, especially concerning asset-backed sukuk, which often requires the establishment of a Special Purpose Vehicle (SPV).

In the context of asset-backed sukuk, the Special Purpose Vehicle (SPV) holds legal and beneficial ownership of the assets. Depending on the country's laws, the Special Purpose Vehicle (SPV) may be subject to corporate tax if considered a taxable entity. Additionally, investors may be liable to pay income tax on the returns generated from the sukuk (Radzi & Lewis, 2015). Currently, only a few countries, including the UK, Malaysia, Qatar, and Turkey, have established favorable tax systems and frameworks for Islamic financial instruments.

For instance, in Turkey, the preferred Islamic financial product is ijarah (Maulana et al., 2021). To address these challenges, Turkey has enacted several sukuk laws. For example, in April 2010, Communiqué Series III No. 43 on "Lease Certificates and Asset Lease Companies" legalized sukuk ijarah as a financial instrument and interest-free financing model. Subsequently, in 2011, Kuveyt Turk Participation Bank issued the first sukuk in Turkey after receiving a tax exemption. Further regulations were introduced in 2013 with Series III Communiqué No. 61 on Rental Certificates, governing various rental certificates, including ijarah sukuk and four other types of sukuk models: musyarakah, murabahah, mudaraba, and Istisna Sukuk (engineering, procurement, and construction) (Erdem, 2014).

Conclusion

The development of Sukuk markets presents both opportunities and challenges for stakeholders in the Islamic finance industry. While Sukuk offer investors diversified investment options and issuers alternative sources of funding, regulatory complexities, liquidity constraints, and market perceptions pose significant challenges. Addressing these challenges requires collaborative efforts from regulators, market participants, and industry stakeholders to foster a conducive environment for Sukuk market growth. By navigating these opportunities and challenges effectively, Sukuk markets can continue to expand, contributing to the broader development of Islamic finance and sustainable economic growth.

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