

## ISLAMIC INVESTMENT: CRITICS ON SUKUK AND BOND

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### Abstract

**Purpose** – In light of the current phenomenal on Islamic investment which is *sukuk*, the purpose of this paper is to study on the development of *sukuk* market and aims to analyze the criticisms raised on *sukuk*, which has more or less affected the growth of *sukuk*. As well as the author is interested to discover the reason why investor would prefer to invest in *sukuk* over bond?

**Design/methodology/approach** – The methodology employed is the conceptual framework of Islamic investment in *sukuk*.

**Findings** – It is found that Islamic investment funds have grown rapidly this decade. However, during the development of *sukuk* there is criticisms and challenges faced which has more or less affected the *sukuk* exponential growth. A closer looks at *sukuk* shows that *sukuk* have several elements that said to resembles conventional bonds, however by focusing on *sukuk* development and its unique features, there are several important differences, which make *sukuk* better than conventional in various aspect.

**Originality/value** – Although several papers already exist in discussing on *sukuk*. However, lack of study has focused on comparing *sukuk* performance with its counterpart's Conventional bond. Thus, the author has provide an analysis on the *sukuk* performance in Malaysia and globally. Along with that, Islamic investment *sukuk* has been proven to be as one competitive investment globally. Therefore, the findings of this paper could be beneficial for investors to realize the true potential of *sukuk* investment as the best investment instrument now and in the future.

**Article Type:** Conceptual paper

**Keyword(s):** Islamic Investment funds; *Sukuk* ; Ethical investment; Islamic Bond

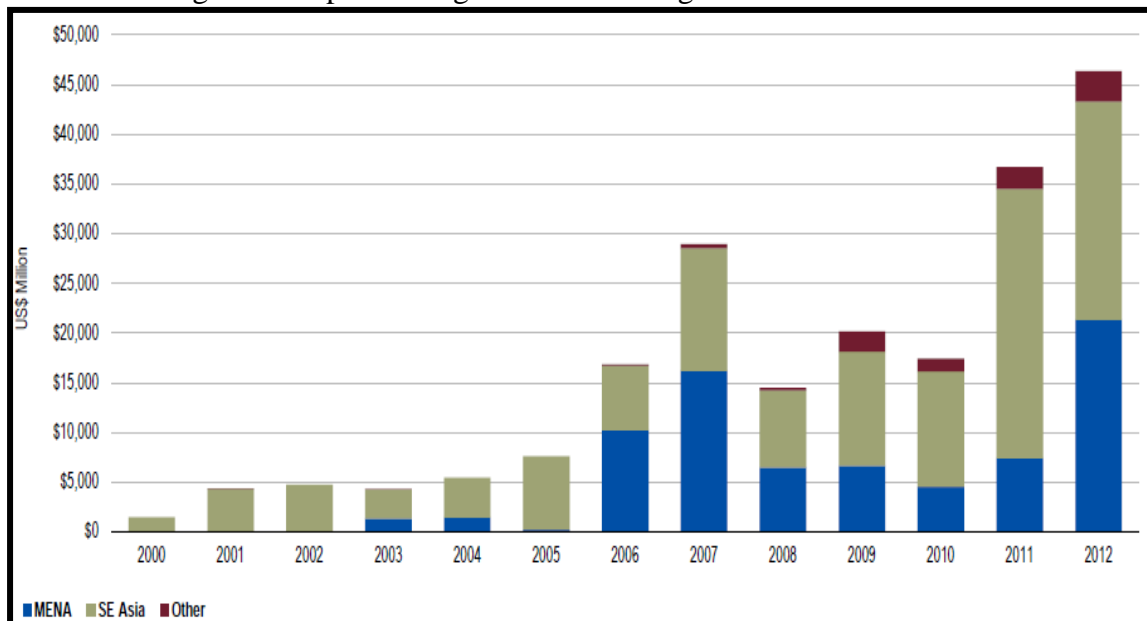
### 1.0 Introduction

The growing rationale of Islamic finance to vibrant investment activities among countries in assembling and organize funds has donate for allocation of funds efficiently across borders and ease the international trade and investment. Besides, another factor that contributes towards promoting international financial services stability is the greater diversification of risks. Recent developments in Islamic finance are the growing implication of the *sukuk* market to become an increasingly important

component of the Islamic financial system and represent as the most significant instrument in the capital market. *Sukuk* has becomes the new trend as investment alternative as well as in the capital market activities in meeting the financial requirements for both the public and private sectors in emerging market economies.

According to Bloomberg (2012), there is over US\$200 billion outstanding *sukuk* globally as at December 31st 2012 the *sukuk* market has grown with improving transparency and liquidity.

Figure 1: Exponential growth in annual global *Sukuk* issuance

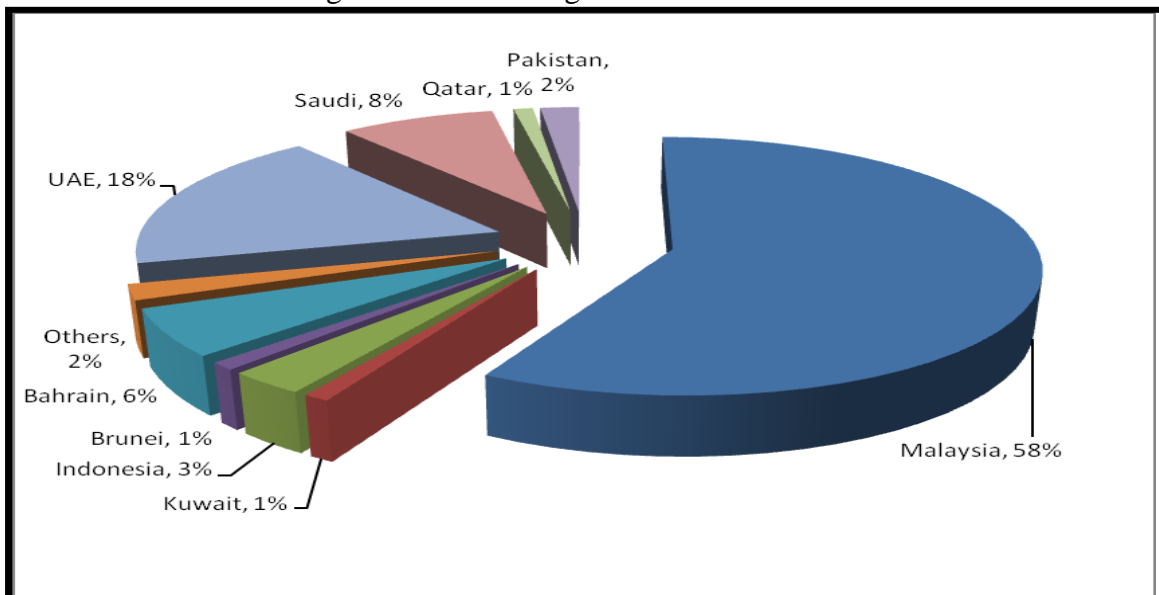


Source: Bloomberg as of 31<sup>st</sup> December 2012.

Malaysia today has become as the Global *Sukuk* Centre in the world. The Islamic capital market in Malaysia has emerged as a significant area of growth. With solid regulatory framework and support from the government in *sukuk* market, Malaysia is acknowledge as one of the most well established bases and become universal *sukuk* hub.

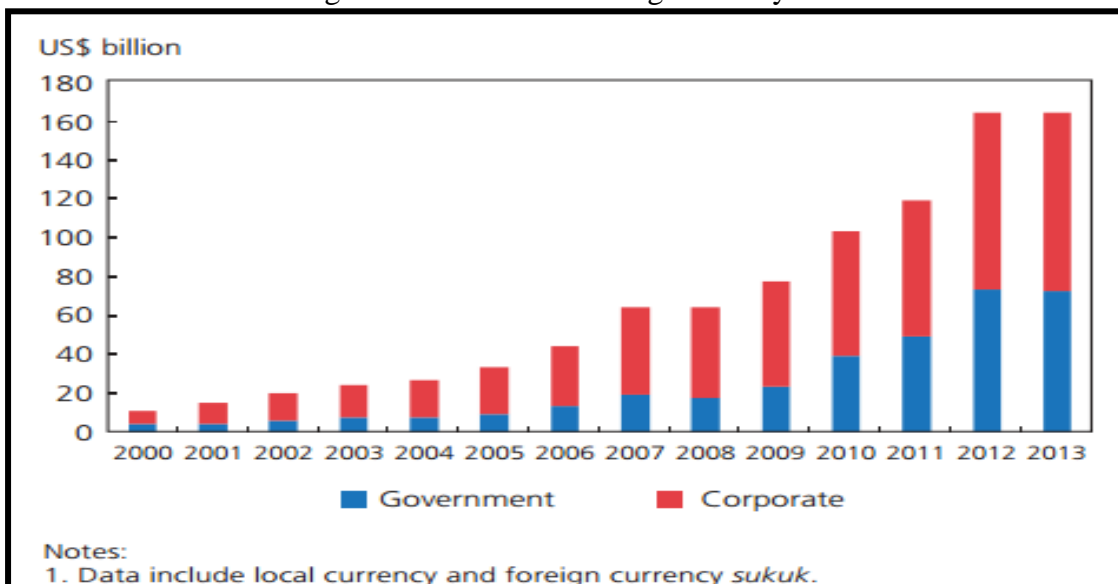
In 2011, Malaysia hold the world's largest *sukuk* market by 58% of total global *sukuk*, accounting for about USD47 billion or two-thirds of the total outstanding Sukuk throughout the world (RAM Rating Services Berhad, 2011). Sukuk tremendously rise on 2013 for 60% with USD83.7 billion in new *sukuk* issuance which make the total *sukuk* outstanding reached to USD163.5 billion (Goswami, 2014). According securities commission Malaysia (SC). The size of Malaysian Islamic capital market is estimated to grow at an average of 10.6% per year to RM2.9 trillion by the year 2020.

Figure 2: Growth of global *sukuk*



Source: ISRA (2011)

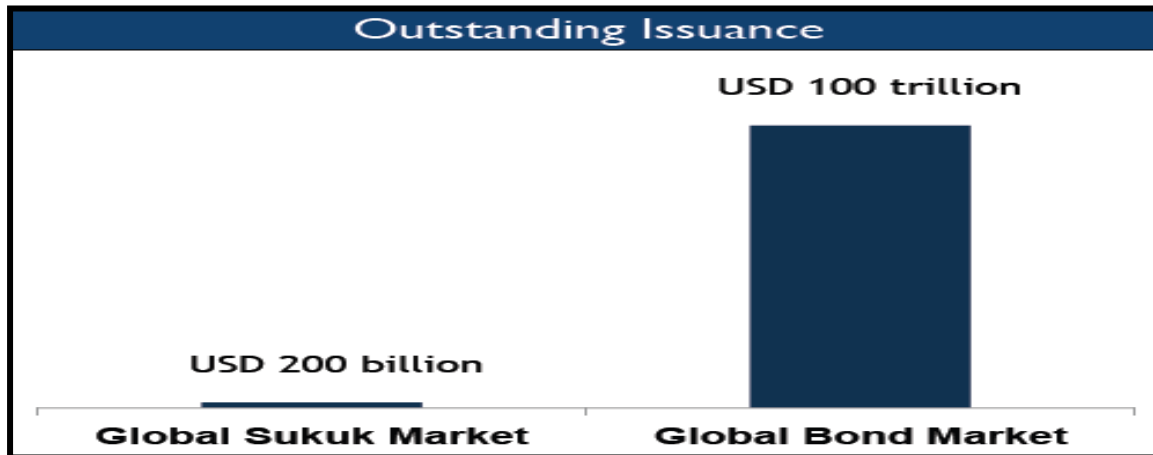
Figure 3: *Sukuk* Outstanding In Malaysia



Source: Asian Development Bank (ADB) Report March 2014

However, in reality by putting *sukuk* and Bond side by side, *sukuk* are still far more to go to compete with conventional bond market in the global market (refer figure 3). Yet, it is not impossible, Islamic financial expertise believe that *sukuk* will have the chance to beats the bond market in future. The gaps between global *sukuk* market with global bond market taken as opportunity and tremendous room for growth in *sukuk* issuance in the future. Besides, large pools of Muslim wealth and abundant liquidity looking for Shariah investment and the demand is currently hugely exceeds supply for *sukuk*. Besides, recently *sukuk* issuances have been heavily over-subscribed (Adib Wealth Management, 2013).

Figure 4: Global Sukuk & Bond Outstanding Issuance.



Source: The City UK, Bond Markets Report 2012

Therefore, the researcher is fascinated to study on the development of *sukuk* market and aims to analyze the criticisms raised on *sukuk*, which has more or less affected the growth of *sukuk* as well as to discover the reason why investor would prefer to invest in *sukuk* over bond?

## 2.0 Concept of *sukuk*

Islamic debt instruments commonly referred to *sukuk*, which is certificates that represent a proportional or undivided interest of asset and in material form of *sukuk*, it is not simply just a cash flow but it is an ownership (Christophe J. Godlewski, 2011; Ahmed, 2011). Technically, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) describes *sukuk* as certificates of equivalent value representing undivided shares in ownership of tangible assets, usufructs and services, assets of particular projects or special investment activity. *Sukuk* also have a maturity date and investor is entitled to an income over the life of the *sukuk* together with a sum at maturity date that is similar to conventional bonds, (Christophe J. Godlewski, 2011). *Sukuk* are the Islamic security that is frequently interpreted the same as “Islamic bonds”. However, the expression “Islamic bond” does not completely explain the essence of *sukuk*. *Sukuk* were essentially introduced as the alternative instrument which serve the same purpose of offering long term investment as bond, however *sukuk* is bound to Shariah guideline (Refer appendix 1).

Therefore, Cakir and Raei (2007) take an opposing view, suggesting that *sukuk* are truly different from conventional bonds. Conventional bonds are proceeding over interest bearing securities. Bonds represent a contractual debt obligation where the investors provide a loan to the issuer. The repayment of bonds consists of the principal capital at the time of maturity and interest in the form of periodic coupon payments (ISRA, 2013).

According to Christophe J. Godlewski (2011), to be Shariah-compliant *sukuk* must fulfill three criteria:

- a) The certificates must stand for ownership in tangible assets, usufruct or services of revenue-generating firms;
- b) Payments to investors is given after calculated from after tax profits
- c) The value repaid at maturity should reflect to the current market price of the underlying asset.

While, according to Afshar (2013), in Shariah principle, *sukuk* must not involve in any prohibited activities such as:

- a) It is absolutely forbidden for a loan to receive or to pay interest (*Riba*). By definition, excess or addition without due consideration are known as *Riba*. As mention in Quran;

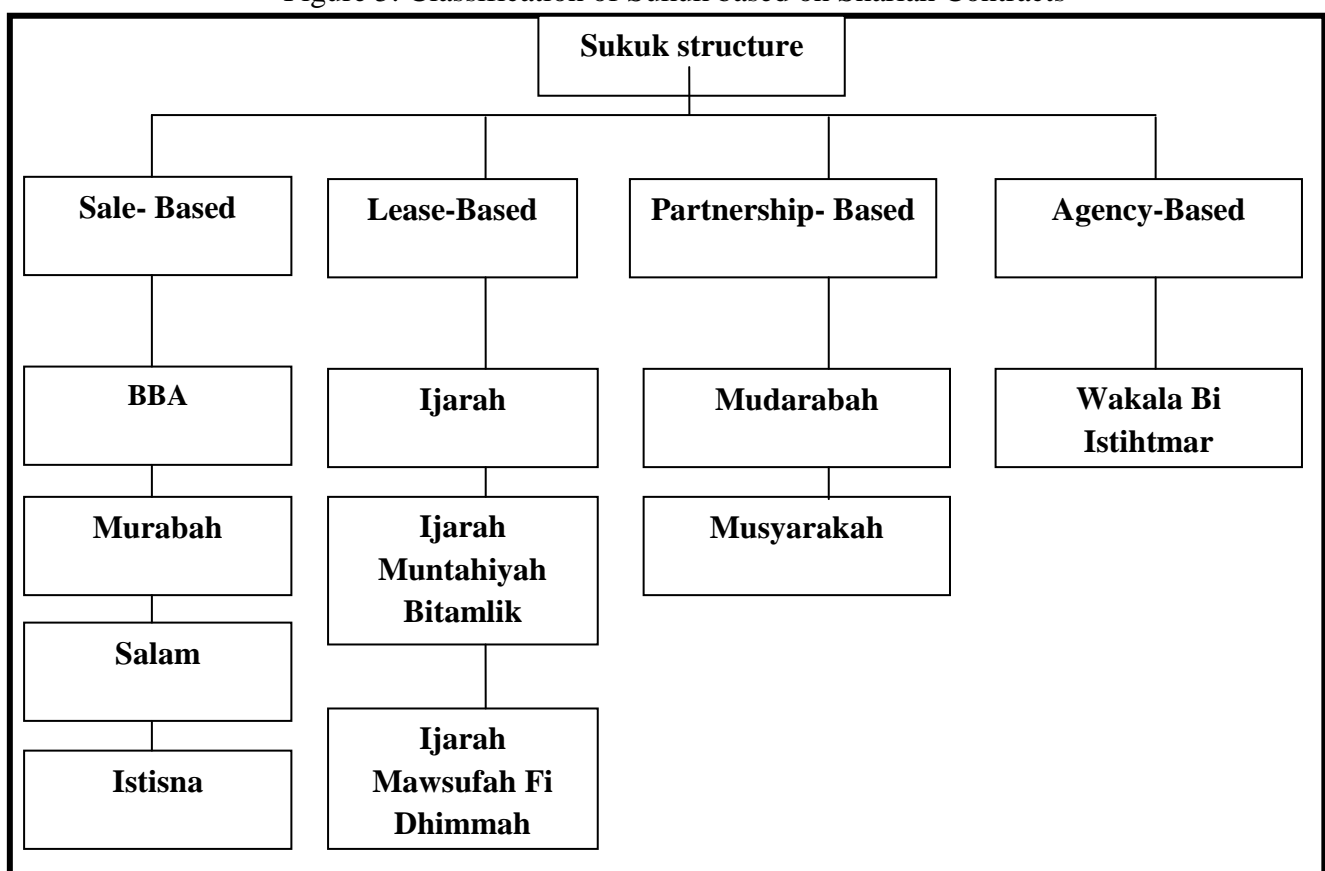
***“If you do not refrain, then expect a war from God and His messenger. But if you repent, then you may keep your principal, without inflicting injustice, or suffering injustice.” (2:279)***

- b) In financial dealings, businesses that involve uncertainty (*Gharar*) should be eliminated. Shariah ruling characterize *Gharar* as a state whose consequences are concealed or unknown. Accordingly, a transaction with inadequate information and thus incurring an excessive risk or interest is totally prohibited.
- c) According to Shariah Principle, money is purely act as medium of exchange and as measuring unit of value. It is not an asset; it. Therefore, money cannot makes money as it will lead to *Riba*, which is completely banned in Islam. For that reason, without the underlying asset, the trading of debts for anything other than its par is impermissible ( Howladar, 2010)
- d) Business that engages with alcohol, pork, illegal drugs, gambling, pornography, and weapons are not allowed.

## 2.1 Sukuk Structures

There are diversifying structures of *sukuk* available for investor in financial market based on Shariah contract. Different structures represent different features and for different purposes. However, *Sukuk Ijarah, Musharakah, Mudarabah, Hybrid, Salam* and *Istisna* are the most significant and familiar type of *sukuk* among investor. Figure 5 will shows the *sukuk* structures while figures 6 exhibits *sukuk* issuances performance based on Shariah contracts.

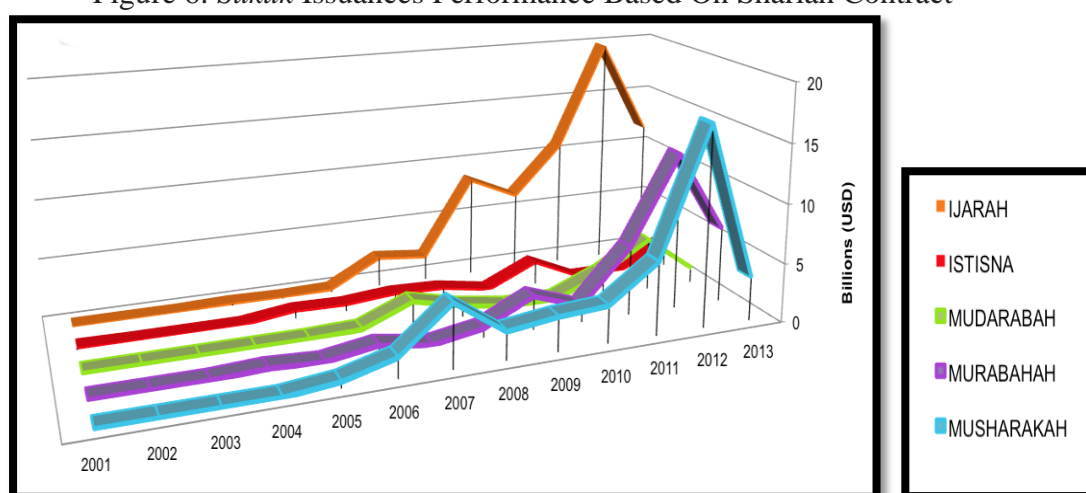
Figure 5: Classification of Sukuk based on Shariah Contracts



Source: Securities Commission Malaysia (2009) and ISRA (2011).

Seeing that Shariah contracts employed in the structuring of *sukuk* (refer Figure 6), it is clear that *Ijarah* and *Musharakah* structures have been among the most well-accepted globally, then follow by the *Murabahah* contract. However, from 2004-2008 *Sukuk Al-Musharakah* issuances increased until Sheikh Taqi Usmani raised negative criticisms against equity-based *sukuk* in 2007. *Sukuk Al-Musharakah* issuances therefore slumped and *Sukuk Al-Ijarah* taken over on 2009 until 2013. However, in 2012 the issuances of *sukuk* by using *Musharakah* contract appear to rise again. Sadly, Malaysian total *sukuk* market has slump to 26 percent in *sukuk* issuance of 2013 due to uncertainty ahead because of the country's general election and a prolonged emerging market sell-off. However, it has started to go up again now (Alderson, 2014).

Figure 6: *Sukuk* Issuances Performance Based On Shariah Contract



Source: Bloomberg

## 2.2 Criticisms of *Sukuk* and the Resolution.

Ever since *sukuk* was introduced in the capital market, there are many criticisms, which are more or less has affected the growth of *sukuk* globally. As at November 2007, the Chairman of the Shariah Board of AAOIFI, Sheikh Taqi Usmani has raised three main criticisms against *sukuk* at AAOIFI's annual event in Bahrain, which is:

- Sukuk* holders not having real ownership interest in the underlying assets;
- The regular distributions to *sukuk* holders not being based on actual performance of the underlying assets; and
- Guarantee of the return on capital via the use of purchase undertakings.

Sheikh Taqi Usmani has explained these issues further in his writing, "*sukuk* and Their Contemporary Implication" in 2008. First, *sukuk* represent ownership shares in assets however, market has witnessed a number of *sukuk* in which there is doubt regarding their representation of ownership. There is no real transfer of ownership of the assets to *sukuk* holders from the company which at the beginning of contract the *sukuk* holders do not have an interest on asset, which conflicts with Shariah principles that require *sukuk* investors to have rights over the *sukuk* assets. This issue also been brought up by Al-Amine (2008), which he mentioned that the mechanism of *sukuk* resembles *bay al-wafa* or *bay al-inah*, which is rejected by the majority of Muslim scholars.

Secondly, the two criticism explain that most of the *sukuk* that have been issued are identical to conventional bonds with regard to the distribution of profits from the companies are fixed percentages of interest rates based on London Inter Bank Offer Rate (LIBOR). Al-Amine (2008) also explained that the issue of guarantee transforms the transaction into a form of *riba al-duyun* and *sukuk* does not follow the actual rental of underlying asset.

However, according to ISRA (2013), at the speed of market demands, International Islamic Fiqh Academy (IFA), the Organization of Islamic Cooperation (OIC) Fiqh Academy the AAOIFI's Board of Shariah has done a commendable job by issuing special guidelines on *sukuk* structures. For instance, in February 2008 AAOIFI stated that there are some activities that are prohibited in equity-based *sukuk*, which is later followed by OIC and IFA by making the same resolution in 2012. Those resolutions are:

- a) The use of Shariah-compliant financing to smooth out periodic income distribution amounts to *sukuk* holders; and
- b) The uses of purchase undertakings in order to guarantee the return of the principal amount to *sukuk* holders at its par value.

More to the point, International Islamic Fiqh Academy (IFA) has prohibited the current structure of asset-based *Sukuk al- Ijarah* that is a sell and buy-back contract or *Bay Al-Inah*. Other than that, IFA also stress on the truth that *sukuk* should have real ownership of assets, which enforceable in law for certain occurrence such as manner of the liability related with ownership.

### 3.0 Findings and Discussion

Islamic finance continued to post robust growth rates for this few recent years. This phenomenal development of the Islamic bond or *sukuk* has spread all over regions. Despite of all criticisms and challenges, which affected the exponential growth of *sukuk* in the financial market, however Islamic financial industry seems to be able to cater and come out with good solutions and *sukuk* seems to be continuously grown due to the *sukuk*'s competitive investment quality proven.

#### 3.1 Benefits of *sukuk* compared to conventional bond.

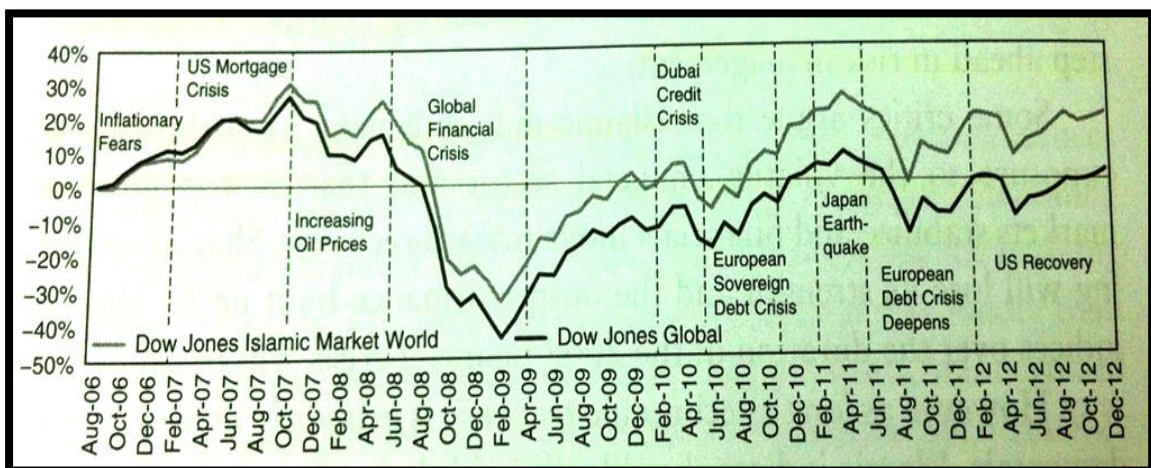
Today, *sukuk* act as an option for shariah compliant's firm and investors. *Sukuk* is one of the major Islamic Shariah compliant financial instruments. Besides, *sukuk* is an innovative debt security, which is akin to the conventional bond with respect to cash flow and risk but different in certain basis which make it better compared to conventional bond (Christophe J. Godlewski, 2011; Cakir and Raei, 2007).

The several important reasons make *sukuk* better than conventional bond. Firstly, return on *sukuk* is expected from principal asset, which is opposite to the conventional bond because their return is based on fixed interest. In certain cases, investors supposedly able to get more return on their invested such as in case of capital appreciation, though, for conventional bonds investor will not receive more return as investment return is fixed (Afshar, 2013). *Sukuk* Investors are pleased with profit sharing grow from the asset and investor do not be paid of interest payments because that would violate Shariah principle.

Second reason is *sukuk* is less volatile compared to conventional bond. Even though, crisis in Dubai in 2010 has shaken a bit the confident of investor to invest in *sukuk*.

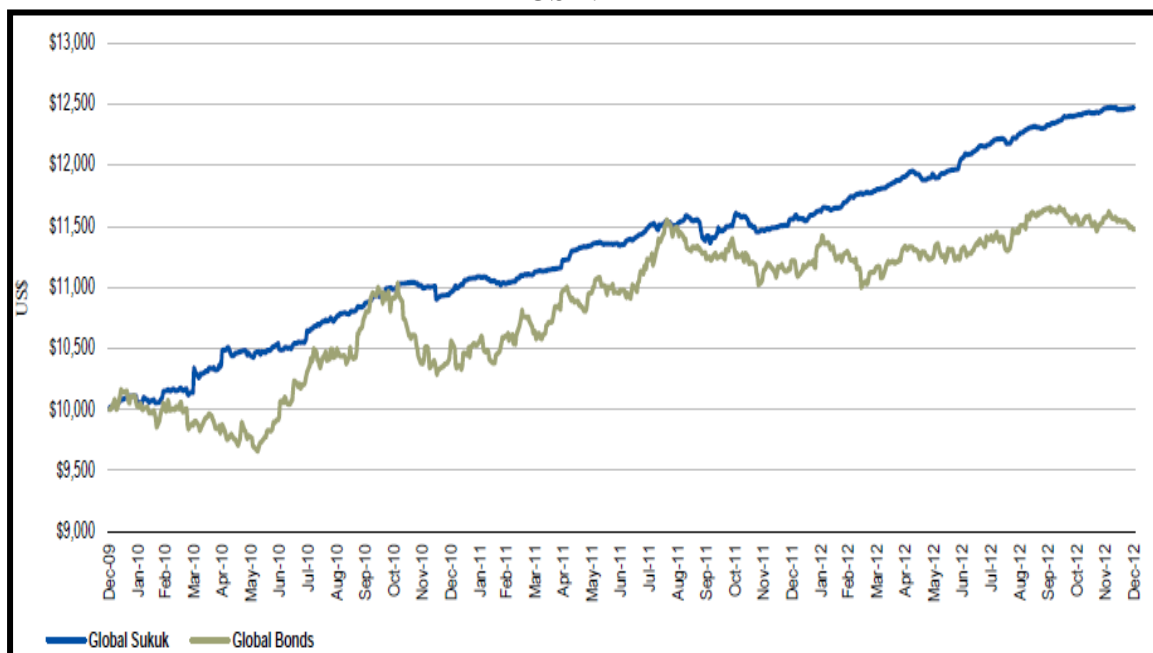
However, it is gradually grasp back the investors confident towards *sukuk* investment. According to Kamso (2013), *sukuk* is proven more resilient and outperformed the conventional bond even in bull market and in the bear market. Through the analysis during the financial crisis it is proven that Islamic fund including *sukuk* are far more resilient, much safer and seems outperformed than its counterpart. With the additional dynamic features of Islamic investment, which is Shariah investment screening has promoting Islamic investment to be more resilience (Refer appendix 2). Besides, provide liquidity to the investors as they can trade it in the secondary market (Bank Islam Malaysia, 2012)

Figure 7: Cumulative Indices Price- Global Market



Source: Bloomberg December 31, 2012.

Figure 8: Global Sukuk Performance. Dow Jones Sukuk Index represents global Sukuk. The JP Morgan GBI Broad Index represents global Bonds. Returns Are in USD.



Source: S&P and JP Morgan as of 31<sup>st</sup> December 2012.



Thirdly, one more features that differentiates *sukuk* and conventional bonds is when the issuer unable reimburses the investors profit, therefore investors will lose the entire the investment because normally bond contract have not based on underlying asset to secure and to recover the principal investment. However, in *sukuk*, since the instrument is based on the underlying asset therefore, even if bad circumstances take place, investors can still compensate their investment to be sheltered by the asset based contract Sukuk (Mohamad Zaid Mohd Zin, 2011).

Fourth, the information disclosure provided by *sukuk* is very useful for investors. Normally, investors may find it hard for them to obtain certain information due to lack of accessibility to the information or the complexity of information itself. Therefore, bridging this information gap between the issuers of debt or *sukuk* and *sukuk*'s investor contract is the best instrument. AAOIFI's FAS 17 has made particular requirements for disclosure in *sukuk* in order for user such as investor to have more information in their investment decision making so investors are able to compare the risks and returns on their investments as well as to ensure to fulfill of Shariah principle requirement (Satoru Yamadera, 2012).

#### 4.0 Conclusion

In today's world, *sukuk* has become the strongest piece in Islamic financial market and it has become an attractive instrument for investors in the form of competitive investment, thus proving the value of Islamic finance in escalating financial industry. Therefore, it is important on figuring the main reason why must investor decides to invest in *sukuk* rather than in conventional bond. Previously, the researcher has highlighted several interesting fact on this matter regarding the study proves that *sukuk* is outperformed compared to its counterpart, besides *sukuk* is more resilient in volatile market and also *sukuk* is more secure in terms of bad occurrence.

The nature of *sukuk* which is lay down on the Shariah principle has open up a broad door for the Muslim's investors as well as for non-Muslim investor to understand about Shariah-compliant instrument and to move beyond *riba* itself. Moreover, especially for Muslim investor, by introducing *sukuk* has creates an alternative investment for Muslim because there is an exception for *sukuk* instrument as Muslim are not encourage involving in debt market. Therefore, as mentioned in the Qur'an says:

***“O ye who believe! Enter into Islam whole heartedly and follow not the footsteps of the devil...” (2: 208).***

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## APPENDICES

### Appendix 1: Distinctive Sukuk from Conventional Bond

	Conventional Bonds	Sukuk
Asset ownership	Bonds do not give the investor a share of ownership in the asset and business. They are a debt obligation from the issuer to the bond holder.	Sukuk give the investor partial ownership in the asset on which the sukuk are based.
Investment criteria	Generally, bonds can be used to finance any asset, project, business, or joint venture that complies with local legislation.	The asset on which sukuk are based must be sharia-compliant.
Issue unit	Each bond represents a share of debt.	Each sukuk represents a share of the underlying asset.
Issue price	The face value of a bond price is based on the issuer's credit worthiness (including its rating).	The face value of sukuk is based on the market value of the underlying asset.
Investment rewards and risks	Bondholders receive regularly scheduled (and often fixed rate) interest payments for the life of the bond, and their principal is guaranteed to be returned at the	Sukuk holders receive a share of profits from the underlying asset (and accept a share of any loss incurred).

	bond's maturity date.	
Effects of costs	Bond holders generally aren't affected by costs related to the asset, project, business, or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.	Sukuk holders are affected by costs related to the underlying asset. Higher costs may translate to lower investor profits and vice versa

## Appendix 2: Shariah Screening Methodology

Quantitative Assessment	Revised Shariah Screening Methodology	Description
Business activity benchmarks	5%	<ul style="list-style-type: none"> <li>conventional banking;</li> <li>conventional insurance;</li> <li>gambling;</li> <li>liquor and liquor-related activities;</li> <li>pork and pork-related activities;</li> <li>non-halal food and beverages;</li> <li>Shariah non-compliant entertainment;</li> <li>interest income from conventional accounts and instruments;</li> <li>tobacco and tobacco-related activities; and</li> <li>other activities deemed non-compliant according to Shariah.</li> </ul>
	20%	<ul style="list-style-type: none"> <li>hotel and resort operations;</li> <li>share trading;</li> <li>stockbroking business;</li> <li>rental received from Shariah non-compliant activities; and</li> <li>other activities deemed non-compliant according to Shariah.</li> </ul>
Financial ratio benchmarks	33%	Not Applicable

### Financial Ratio Benchmarks

The financial ratios applied are as follows:

<b>i) Cash over Total Assets</b>	Cash will only include cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments will be excluded from the calculation.
<b>ii) Debt over Total Assets</b>	Debt will only include interest-bearing debt whereas Islamic debt/financing or <i>sukuk</i> will be excluded from the calculation. Both ratios, which are intended to measure <i>riba</i> and <i>riba</i> -based elements within a company's balance sheet, must be lower than 33%.