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Current Issues of the Sukuk Market and Using Sukuk for the Global Infrastructure Projects

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CURRENT ISSUES OF THE SUKUK MARKET AND USING SUKUK FOR THE GLOBAL INFRASTRUCTURE PROJECTS

Abstract

The sukuk market has proven its usefulness as a significant source of capital for the public and private sector entities. As a result, the sukuk market has gained great popularity both in the Islamic and the non-Islamic countries. The sukuk market has a flexible nature in product structuring and poised to grow even further. On the other hand, the public financing of infrastructure is a worldwide problem in today's world. World Economic Forum reports an annual infrastructure financing gap of \$1 trillion. As a fast growing segment of the Islamic finance, the sukuk market has significant potential to bridge that gap. However, only a small part of the great potential of sukuk has been released until now. Although huge as it is today, the sukuk market still suffers from the illiquidity of the secondary market for sukuk instruments. The yield curve for sukuk products is still incomplete and regular sovereign issuances is most needed as part of governments' debt financing programs. That could serve as a benchmark for pricing so corporate sukuk market could develop further. However, there are a myriad questions to answer regarding the public financial management issues before making sukuk issuances an integral part of sovereign debt management policies. Safety nets, resolution frameworks are missing in many jurisdictions. Investors are facing many more risks beyond the conventional fixed-income instruments but they are not adequately protected. There are many complex sukuk structures but there is not sufficient harmonization of shari'ah ruling or legal treatment regarding those products at the international level. Once these problems were resolved, the sukuk market in theory could be much more useful in providing funds to infrastructure projects all around the world. This paper documents the contemporary issues that need to be addressed in the sukuk market and discusses whether the sukuk market could be used to channelize the needed funds for the infrastructural projects.

Keywords: Sukuk, Infrastructure Financing Gap, Islamic Finance

JEL Codes: E44, E52, G18, H29, O16

1. Introduction

“...the Sukuk market has great potential to function as a bridge between the growing pools of Shari’ah-compliant capital, on one hand, and the massive need for poverty alleviation funding, on the other. In lack it would be a great missed opportunity if a thriving socially responsible Sukuk market fails to develop, given that the explicitly ethical nature of Islamic finance creates a natural rationale for using Sukuk as a development tool”.

Bennet and Iqbal (2011)

Although Islamic Finance and the Religion Islam are coeval, the resurgence of Shari’ah-compliant financial practices in the modern era only dates back to the 1970s. However, we have witnessed an upsurge in Islamic Finance with the beginning of the 2000s and Islamic Finance gained worldwide popularity especially after the Great Recession in 2008. Today, the global Islamic Finance market is larger. It has more participants. More transactions are done. And there exist more varied products some of which are highly complex. This upward trend is set to continue in the foreseeable future.

That is a promising situation for the whole world because Islamic Finance, based on the principles of active participation and risk sharing, has great potential to address some of the most pressing financial concerns of our age. Islamic Finance could foster economic growth in emerging countries in a more inclusive manner. It is also believed to pose less systemic risk than the conventional finance. It could provide the much-needed financial support to SMEs and finally Islamic Financial markets can provide an answer to the global infrastructure financing gap problem.

Nevertheless, the state of the Islamic Financial markets today is not hassle-free. As national and global Islamic Finance markets were growing, some unanswered questions have piled up. Today, it is clear that we need stronger and dedicated regulatory and supervisory structures in Islamic countries. We also need harmonization and further clarity for cross-border transactions. Shari’ah-compliant deposit insurance schemes are either underdeveloped or nonexistent in many countries. Resolution frameworks are still unclear and underdeveloped. Many countries still suffer from lack of trained human resources. The problems that Basel III would pose for Islamic Finance institutions are not yet addressed adequately. Islamic Finance is still developing without thorough understanding of the microeconomic foundations of the system. There exist monetary policy issues that need to be answered especially for dual systems where Islamic Finance and conventional finance coexist but also for pure Islamic Finance systems. In addition to these, there are the specific problems of the sukuk market.

2. The Current Issues in the Sukuk Market

Regular sovereign issuance at different maturities is critical to deepening the sukuk market and establishing a yield curve that could provide a benchmark for corporate sukuk. Currently, only a handful of governments have sukuk issuance programs as part of their public debt management strategy. However, there is still no international standardization in the accounting and statistical treatment of sukuk products and such ambiguity would distort the credibility of debt sustainability projections if governments relied heavily on sukuk instruments. In fact, with regard to whole range of public financial management purposes we need an internationally accepted guideline for the treatment of sukuk and special purpose vehicles. Then, governments could more effectively implement strategies to develop local currency sukuk markets by making sovereign issuances as part of their debt management plans. The governmental will to establish regular sukuk issuances could help deepening the market once these issues are resolved.

However, the sukuk market should also be more liquid than it is today. The lack of interbank money markets and central bank open market operations restrict the liquidity of the market. Sukuk are usually complex structured products that involve market risk, underlying asset risk, and regulatory and operational risks. Plus Shari'ah risk exists – i.e. the possibility that the transaction will be subsequently found non-compliant - and insufficiency of secondary markets render those risks untransferable. All of these go beyond the typical credit risk of conventional fixed-income securities. Therefore, it is important to strengthen bankruptcy and insolvency regimes, develop within and cross-border resolution regimes, and foster consumer/investor literacy.

3. The Infrastructure Gap Problem

Available long-term financing is far from satisfying the investment needs of both the developed and the developing countries. This problem is going to be one of the issues that will continuously be discussed by the post-2015 Sustainable Development Goals, which has replaced the Millennium Development Goals. The gap is especially significant when it comes to infrastructure finance. As stated in the World Bank's latest Global Financial Development Report, "a 2014 UN report on sustainable development financing estimates financing needs for infrastructure projects—water, agriculture, telecommunications, power, transport, building, industrial, and forestry sectors—at \$5– 7 trillion annually. The OECD estimates a global infrastructure requirement by 2030 on the order of \$50 trillion." That is why, the OECD reports "the problem of public financing of infrastructure is a topic on top of policymakers' agendas worldwide. Budget constraints, past experiments of poor public spending and inefficiencies in managing infrastructure on the public side

have led to a reconsideration of the need to shift the investment effort to the private sector and to the development of Public Private Partnerships (PPPs). However, the gap to be filled is remarkable.” To be more precise, an annual infrastructure financing gap of \$1 trillion is estimated by the World Economic Forum.

To increase welfare around the globe, alleviate environmental problems and secure a healthy growth path for the global economy, we have to find the ways to undertake the needed infrastructure investments. The sukuk market has great potential to effectively address this global problem.

4. Can Sukuk Market Provide the Needed Funds?

In theory, the risk-sharing feature of Islamic Finance gives the sukuk market clear advantage as a financing tool for infrastructure projects. As pointed out by Kammer et al. (2015), nearly all conventional infrastructure projects contain separate equity and debt components, which leads to a concentration of risk in the equity tranche. Sukuk are designed from the outset to spread the risk more broadly because all investors share in the same manner.

Once these missing parts are resolved, the market is flexible enough to grow further to become very deep and liquid. Even today, the sukuk market has proven its value for long-term and large infrastructure projects. Some recent sukuk issuances, such as the issuances made by Malaysia and Saudi Electricity Company in the last two years, have shown us that the global investment community is ready to provide billions of dollars of funds to the sukuk instruments up to 30 years. Plus, the market is highly capable of engineering products that are specific to the needs of the projects.

5. Conclusions

Islamic Financial products have come to prominence especially in the aftermath of the Global Depression in 2008. The sukuk market within this domain has gained great popularity as a significant source of capital for the public and private sector entities both in the Islamic and the non-Islamic countries. The sukuk market has a flexible nature in product structuring and poised to grow even further.

Nonetheless, the sukuk market is not hassle-free. The sukuk market is still highly illiquid in the secondary market and that makes risk transfer and liquidity management a problem for the sukuk investors. If we exclude regions such as Malaysia, sukuk instruments have pricing issues as well since the yield curve for sukuk products is still incomplete. Regular sovereign issuances would help

completing the yield curve however overreliance on sukuk makes governments' debt projections unreliable since the sukuk products do not have standardized statistical and accounting practices all over the world. Safety nets and resolution frameworks are missing in many jurisdictions. Investors are facing many more risks beyond the conventional fixed-income instruments but they are not adequately protected. There are many complex sukuk structures but there is not sufficient harmonization of shari'ah ruling or legal treatment regarding those products at the international level.

If these problems were resolved, the sukuk market could be much more useful in providing funds to infrastructure projects all around the world. That would be an immense service since the world is now facing a gap of annual \$1 trillion in the long-term financing of much needed infrastructure projects.

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