Innovations in Sukuk in the Global Finance Market: Reviewing Key Considerations

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Abstract
Sukuk is one of the fast-growing financial areas in Islamic finance. This paper reviews innovative sukuk instruments in the global financial market in addition to looking at key considerations in facilitating innovative sukuk structures. Using secondary data collected from official reports and peer-reviewed journal articles the authors analysed five types of innovative sukuk structures offered in the market over the past decade. This paper also looks into the enabling role of Securities Commission Malaysia in promoting Malaysia as the top issuer of sukuk. The data analysed shows that sukuk issuers in Malaysia would benefit from high levels of government support through policy and incentives.

Keywords: Shariah compliance; Islamic Capital Market; Sukuk; Sukuk Innovation; Securities Commission Malaysia

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1. Introduction

Similar to a bond in Western finance, sukuk is an Islamic financial certificate that is commonly used for raising funds in accordance with Shariah principles. The sukuk market is a fast-growing segment of the Islamic finance industry; the overall growth of the sukuk market over the last 15 years amounted to a compound annual growth rate of 30.6% (Islamic Financial Services Board, 2019). Sukuk has played a key role in financing infrastructure and renewable energy projects (Aassouli et al. 2018). According to the Islamic Financial Services Board (IFSB) (2019), Malaysia is the largest sukuk issuer in the world, with 47% share of the total sukuk outstanding. The key drivers for sukuk issuance include: expanding investor base, meeting demand for Shariah-compliant financial market instruments, offering alternative financing to global investors (Alam et al., 2013).

Like conventional bonds, sukuk is issued with a specific maturity date. The main difference between a conventional bond and sukuk is asset ownership. Unlike a conventional bond which is considered as a debt obligation, sukuk is backed by tangible assets. Sukuk holders own part of the underlying assets and they are rewarded with a share of the profit derived from the asset (Alam et al., 2013). In addition to financial law, sukuk issuance is subject to Shariah law. A conventional bond is an instrument of indebtedness of the bond issuer to the holders; such indebtedness is discouraged in Islam. Returns and cash flows related to a sukuk must be backed by tangible assets because the fundamental of Islamic economics is to engage in real business, not debt obligation. Scholars proposed that sukuk could be used for many different purposes, for example, funding waqf development (Shukri et al., 2019), financing healthcare (Badeeu et al., 2019), or supporting humanitarian projects (Mohsin, 2019).

This paper reviews innovations in sukuk over the past few years and the current practices of Securities Commission Malaysia (SCM) in coping with innovations in sukuk. SCM is selected because of their advanced efforts in developing a robust legal framework for sukuk issuance and the Islamic capital market in general. This paper is structured as follows; after the introductory section, the second section presents an evaluation of the innovations in sukuk in the global finance market, the third section discusses key considerations that are essential for the innovations in sukuk, the fourth section looks into the Securities Commission Malaysia's best practices in relation to innovations of sukuk, the fifth section is the final section concluding this paper.

2. Innovations in Sukuk

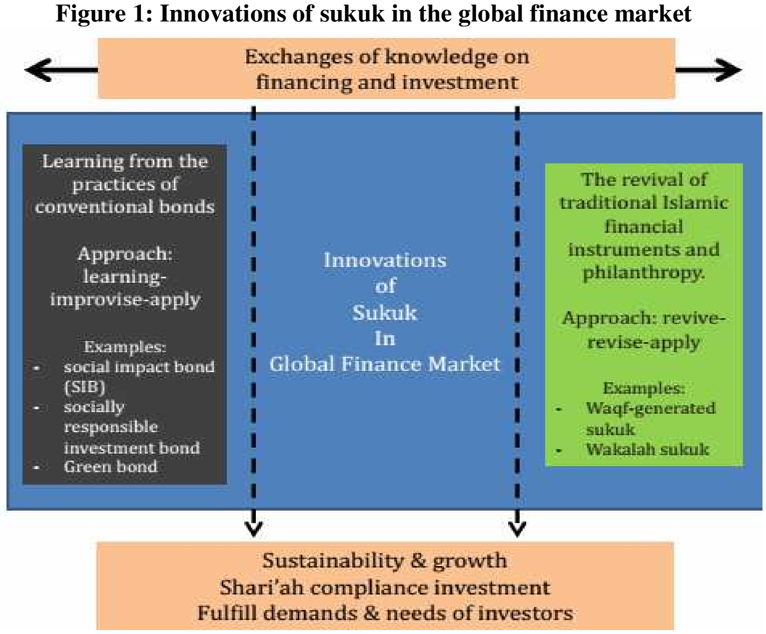
Sukuk offers a large potential for the growth of Islamic finance. Islamic financial institutions have introduced several innovative transactions to attract global investors while at the same time complying with Shariah principles (Aassouli et al. 2018). Sukuk can be structured using single or multiple Islamic contracts such as Ijarah (leasing), musharakah and Mudarabah (partnership), wakalah (agency) and others. Such flexibility allows room for issuers to be innovative in addressing specific financing needs. The Zamzam Tower project in Mecca serves as a good example here. The developer issued Sukuk al Intifa as a fund raising mechanism to build four towers, a shopping complex and a hotel under the Zamzam Tower project (Shukri et al., 2019).

Sukuk holders own the lease of an apartment for a period of one to two weeks. Alternatively, sukuk holders can sub-let the units on a time-share basis. In this way, the sukuk issuer raised funding from investors across the globe while the sukuk holders gained through the time utility or benefitted from the use of the property.

According to Wilson (2008), the key to sukuk innovation is to focus on pricing and risk characteristics. Sukuk offers lower rate of returns compared to conventional bonds (Cakir and Raei, 2007) and thus the pricing mechanism for sukuk should be structured in a way that meets financial interests of global investors without violating Shariah principles. Unlike conventional bond holders, sukuk holders may not receive the principal amount in the event of underperforming sukuk due to the profit and risk sharing principle under Shariah law. Such mechanisms may lower attractiveness of sukuk for potential investors. The attraction for sukuk investors would be that there was an early or predefined exit (Wilson, 2008).

Cakir and Raei (2007) argue that sukuk provide diversification benefits which reduce portfolio risk. Using hypothetical bond portfolios consisting of sukuk and Eurobonds, Cakir and Raei (2007) calculated and compared the value-at-risk (VaR) for a portfolio including both instruments to another portfolio consisting of Eurobonds only. The results show that sukuk has diversification advantages for the investors. The study of Cakir and Raei (2007) is backed by a more recent study of Usman et al (2019), which used the Copula VaR technique to study the dependence structure between Islamic and conventional stocks in five countries for the period 2004–2016. Consistent with the study of Cakir and Raei (2007), Usman et al (2019) concluded that sukuk offers diversification benefits to investors. However, Cakir and Raei (2007) also highlighted that sukuk is an illiquid instrument compared to conventional bonds because of the lack of secondary market activity which imposes a high level of risks on portfolio during market volatility.

Figure 1: Innovations of sukuk in the global finance market



In analysing sukuk innovation, this paper reviews five types of sukuk which have the potential to become a new asset class for both religiously motivated and socially responsible investors: social impact bond; socially responsible investment sukuk; green sukuk; waqf sukuk; wakalah sukuk. Figure 1 illustrates the innovation of sukuk in the global finance market.

2.1. Social impact bond

While all bonds are considered as debt instruments, the Social Impact Bond (SIB) shares the features of both equity and debt. The returns vary depending on the performance of the project which could be seen as dividends on equity. There may be the risk of total loss in a social impact bond because the investments are not secured by real assets or cash flows (Marwan and Haneef, 2019). The social impact bond can also be seen as a composite of loan and equity because there are some social impact bonds structured in a way that holders receive their returns based on pegged rates, just like a fixed income financial instrument. The flexibility of social impact bond makes it an innovative form of financial instrument that is built upon social impact (Marwan and Haneef, 2019).

The first social impact bond was issued on 2010 to finance a prisoner rehabilitation programme in the UK (Liang et al., 2014). Typically, governments are solely responsible for funding rehabilitation or social programmes, which naturally adds to government budget. The issuance of a social impact bond allows the UK government to seek funding from private investors, who are willing to take on financial risks. The government then pays investors a return, which is generated from the savings (Liang et al., 2014) if the programme meets certain performance indicators such as reduced re-conviction rate and increased employment rate. Since then, the idea of a social impact bond has generated growing interest worldwide. However, the social impact bond is still at its early stage, with limited scope and commitment (Deloitte, 2018).

It is believed here that sukuk issuers could learn from the salient features of SIB and avoid prohibited elements under Shariah principles. Marwan and Haneef (2019) proposed a social impact sukuk model which integrates the key aspects learned from the social impact bond, which include prioritising social impact, measurable success indicators, data and management systems, flexible contracts, third sector integration, risk sharing and fostering the culture of innovation.

2.2. Sustainable and Responsible Investment Sukuk

The term Sustainable and Responsible Investment (SRI) covers any type of investment which combines the financial interests of investors and also their concerns regarding environmental, societal and governance issues (Mahfouz and Hassan, 2013). Also known as Socially Responsible Investment, SRI is more about financing good causes. In accordance with the Shariah principles of profit and risk sharing and also the prohibition of unfair and speculative investment, SRI Sukuk is a viable option to address global needs for ethical investment. Like ordinary sukuk, the SRI Sukuk issuer raises funding from a pool of investors and the sukuk holder receives periodic payment. The key difference is that the issuance of SRI Sukuk is designed for the purpose of funding humanitarian projects such as healthcare and education programmes. Depending on the terms and conditions, SRI Sukuk holders have the option to convert their investment into a donation at any point of in time (Noordin et al., 2018). In this light, SRI Sukuk holders are not just investors but also contributors to the project.

Prime examples of SRI Sukuk include vaccine sukuk issued by the International Finance Facility for Immunization and SRI Sukuk issued by Khazanah Nasional Berhad in Malaysia to improve the accessibility of quality education in Malaysian government schools. The first SRI Sukuk, vaccine sukuk, aimed to finance child immunisation in some of the poorest countries of the world. The issuance of vaccine sukuk was warmly received by the investors (Badeeu et al., 2019). More notably, the second issuance of vaccine sukuk was oversubscribed by 1.6 times and the success of the vaccine sukuk also indicated that investing in good causes provides both economic and social returns (Bennett, 2015). However, SRI Sukuk remains limited and needs to be expanded with government support.

In 2014, Securities Commission Malaysia launched SRI Sukuk Framework to facilitate and promote socially responsible investing. The framework covers a broad range of eligible projects which aim to: 1) improve the quality of life for society; 2) reduce greenhouse gas emissions; 3) increase the use of renewable energy; 4) protect the environment and preserve natural resources; 5) promote the use of energy-efficient solutions. Islamic endowment (waqf) development or projects that aim to redevelop idle waqf land are also eligible under the SRI Sukuk Framework. Moreover, the framework specifies disclosure requirements for the sukuk issuer, including details of the SRI project and its impact, and a statement confirming that the issuer has complied with governance standards, or obtained independent verification. The appointment of an independent party is deemed necessary under the framework because it adds transparency to the project, together with proper reporting and disclosure prepared for the SRI Sukuk stakeholders (Noordin et al., 2018).

2.3. Green sukuk

Applying environmental labelling to traditional bonds, the green bond (also known as climate bond), is used for financing green and climate projects (Clapp and Pillay, 2017). Like the green bond, green sukuk is designed to finance green and climate projects (Abdul Aziz and Zhang, 2019). Green sukuk fits into the category of "renewable energy and energy efficient" under the Sustainable Responsible Investment Sukuk Framework issued by Securities Commission Malaysia in 2017. The main objectives of issuing green sukuk and bonds include: first, to protect and preserve the environment; second, to reduce greenhouse gas emissions; and third, to develop energy efficient solutions (Clapp and Pillay, 2017).

A growing number of green sukuk have been issued around the world. A consortium of two Brisbane solar companies, Solar Guys International and Mitabu generated approximately USD100 million through green sukuk in order to finance a photovoltaic project in Indonesia (Vizcaino, 2013). Following the first green sukuk issued by Tadau

Energy in Malaysia, Indonesia issued the first green sovereign sukuk in 2018 (Securities Commission Malaysia, 2019).

The prospect of Islamic green finance contributing to a more inclusive global growth and sustainable development is on the rise. Although the supply of Islamic green financial instruments is still at its infancy globally, it is important to focus on building the Islamic finance ecosystem and also developing standards for good corporate governance and quality management. Good governance allows socially responsible and Muslim investors to make informed decisions that are consistent with their values and beliefs without being exposed to systematic risk (Mahfouz and Hassan, 2013). Third-party certifications on environmental impact, social impact and Shariah compliance increase transparency and confidence among investors. A good example of the certification of environmental friendly projects or green building is the Merdeka Asean SRI Green Sukuk, which aimed to fund an energy-efficient tower project. The project gained a platinum sustainability certification under Malaysian Green Building Index (GBI), Malaysian GreenRE program (Securities Commission Malaysia, 2019).

2.4. Waqf sukuk

As an Islamic social financial instrument, waqf can be understood as "the assets or investments which are given by their owners based on the concept of trust where the proceeds are meant to be utilized for sake of public at large" (Engku Ali and Mohd. Zain, 2017: 136). More commonly known as charitable endowment in Islam, waqf assets or land are typically used for religious or charitable purposes (Mohsin, 2019). The practice of waqf can be traced back to the 8th century (Engku Ali and Mohd Zain, 2017) and waqf has been used for funding religious establishments and schools as well as financing charitable projects (Mohsin, 2019).

Waqf sukuk is a combination of sukuk and Waqf assets. There are two types of waqf sukuk: waqf-based sukuk and waqf-generated sukuk. While waqf-based sukuk refers to the issuance of sukuk in order to develop and maintain a waqf property, waqf-generated sukuk refers to the issuance of sukuk in order to fund charitable projects using income generated from waqf property. Amongst the most notable waqf sukuk include the construction of the Zamzam Tower in Mecca and redevelopment of an old mosque in Singapore (Shukri et al., 2019).

In mid 2000s, Majlis Ugama Islam Singapore (MUIS) issued sukuk for the purpose of redeveloping an old mosque in disrepair and building a mixed development in the city centre of Singapore. The mixed development includes commercial and residential units and the rental received from the mixed development contributes a significant portion of the total waqf fund for MUIS (Shukri et al., 2019). A large part of the rental incomes is paid to the sukuk holders and the remainder was distributed to MUIS and its subsidiary, Warees Investment, which manage the waqf fund on behalf of MUIS (Brown, 2008).

Syed Ali (2018) proposed the idea of Waqf-Aligned Development Targeted Sukuk, which could be used as a financing mode for public-private partnerships. In this way, idle waqf land could be developed by bringing in a diversified investor base such a socially inclined impact investors, philanthropist and profit-oriented investors if the sukuk is well-structured and backed by the government.

2.5. Wakalah sukuk

Wakalah sukuk is another sukuk innovation in past few years. The literal meaning of Wakalah is agency. The principal (investor) appoints an agent (wakeel) to invest funds and the principal will then use the profit return to fund the periodic distribution amounts. Any excess from the periodic distribution amounts is paid to the wakeel as an incentive fee (Razak et al., 2019). Wakalah sukuk is suitable for issuing sukuk comprised of both tangible and intangible assets, giving issuers flexibility in selecting underlying assets (Aassouli et al., 2018) that otherwise would be considered non-tradable debt arrangements as part of the investment portfolio comprising the sukuk assets. Intangible assets include Shariah-compliant shares and receivables (Deloitte, 2018); however, 30 percent of the investment portfolio must be tangible assets (Razak et al., 2019).

Wakalah sukuk could help governments to pool infrastructure and energy projects to provide competitive and inclusive financing (Aassouli et al., 2018). In 2017, a Malaysian property and construction company Bina Darulaman Bhd. issued a wakalah sukuk for infrastructure development, working capital for existing and future projects and other corporate purposes (The Star, 2017). Besides funding construction projects and infrastructure development, wakalah sukuk is also suitable for financing other projects, namely renewable energy projects. A prime example of using wakalah sukuk to finance an energy project is West African Development Bank, the first non-sovereign issuer in the regional capital market (Aassouli et al., 2018). It has an investment-grade rating of BBB given by Fitch and Baa, 1 by Moody's.

3. Innovation of sukuk in the global finance market: some key considerations

The innovation in sukuk over the past decade is remarkable. In the light of financial innovations, there are four key considerations for issuing innovative sukuk effectively.

(a) Legal framework: Muslim Majority countries have made progressive efforts in ensuring the Shariah compliance of Islamic financial products. Regulators and key industry players in these countries develop a series of policy and efforts to harmonise their existing laws with Shariah principles. The expansion of sukuk to other countries that have purely secular jurisdictions faces challenges meeting Shariah principles. This can be observed in Muslim minority countries such as Japan and Italy.

(b) Shariah governance: Shariah governance is essential to Islamic finance and thus the issuance of sukuk should follow the guidelines of Shariah governance. In addition to regular Shariah review, the issuance of sukuk should be assessed by independent parties such as auditors, assessors and risk market analysts.

(c) The underlying contracts of sukuk: In contrast to the conventional bonds, sukuk issuance is closely tied with underlying contracts. The underlying contracts determine the structure of sukuk and the obligations of the contracting parties. However, contract validity may be challenged in countries that do not recognise Shariah principles.

(d) Purposes of the sukuk: The purposes of sukuk issuance should also be considered by financial institutions to avoid violation of Shariah principles. Without having a clear purpose or noble cause, the issuance of sukuk becomes a tool to pool funds from investors which slightly deviated from the underlying principles of wealth distribution in Islam. A well-defined purpose also increases the confidence level of potential investors. Moreover, enhancing Shariah governance with noble objectives will not only improve the functionality of sukuk but also integrate sukuk more effectively with investors and capital market (Deloitte, 2018).

4. Best practices of Securities Commission Malaysia

Malaysia is the largest sukuk issuer (IFSB, 2019) and has an established Islamic capital market. Securities Commission Malaysia (SCM) is the main regulator for both Islamic and conventional capital markets in Malaysia. SCM was established on 1st of March 1993, under the Securities Commission Act 1993. The Islamic and conventional capital markets in Malaysia are steadily growing over the years. However, the diversification benefits of sukuk (Cakir and Raei, 2007) attract more interest in Malaysia in comparison to conventional bonds. As Malaysia is a well-known global Islamic finance hub, it is thus imperative to evaluate the best practices of SCM in managing financial innovation. There are three main best practices that can be found from the Securities Commission Malaysia in relation to innovations of sukuk, which are as follows:

(a) A specific framework for sustainable and responsible investment: The Sustainable Responsible Investment Sukuk Framework issued by SCM in 2017 clearly provides the guidelines for issuing sukuk for sustainable and responsible investments. The framework also promotes sustainable and ethical investment because it specifies reporting and disclosure requirements as well as the use of the proceeds from sukuk. The framework also maintains the importance of appointing independent experts as part of corporate governance and Shariah audit.

(b) Two tier levels of Shariah advisory: There are two-tier levels of Shariah advisory in order to ensure Shariah compliance, as a part of Shariah governance. At the organization level, it is mandatory to appoint an independent Shariah advisor advising the sukuk issuers in matters related to Shariah. At the national level, Securities Commission Malaysia established the Shariah Advisory Council which is responsible for issuing Islamic rulings and resolutions. They are also responsible for screening the businesses and activities of the sukuk issuers. Moreover, the Securities Commission Malaysia takes seriously protecting their investors through an efficient framework for fund-raising and product innovation (Securities Commission Malaysia, 2017).

(c) Tax incentives: under the Sustainable Responsible Investment Sukuk Framework, sukuk issuers are given tax incentives. Such tax incentives include: (i) tax deductions on issuance costs of sukuk; (ii) tax incentives for green technology-based activities; and (iii) grants under Green Technology Financing Scheme (Securities Commission Malaysia, 2017).

5. Conclusion

As derived from the classical principles of Shariah, the modern world continues to see the use of sukuk in the existing global capital market. In order to catch up with changes in the global financial market, innovations in sukuk are necessary to meet the needs and demands of investors and the objectives of sukuk issuances. There are various types of innovations in sukuk issuances such as social impact sukuk, socially responsible investment sukuk (SRI), green sukuk (GS), waqf sukuk (WGS) and wakalah sukuk. There are also efforts made to continue sukuk issuances with other innovations. Regardless of how advanced the innovations of sukuk are, it is important to make sure that the sukuk is in compliance with Shariah and existing laws. Thus, it is important for practitioners, especially amongst sukuk issuers, to follow best practices in generating innovations in sukuk and their key considerations.

It is found that SCM has best practices that may be followed in other jurisdictions. The best practices of SCM in facing innovations in sukuk depend on the framework for sustainable and responsible investment, two-tier Shariah advice to ensure Shariah-compliance, and tax incentives. In the implementation of such best practices, it is necessary to contemplate the key considerations in developing innovations in sukuk. Such key considerations depend on the legal framework, Shariah governance, the underlying contracts of sukuk innovations and the purposes of said innovations.

Innovations in sukuk are important in facing competition among the players in the global finance market. Exchange of knowledge in financing and investment is necessary between the practices of conventional bonds and sukuk. Such exchange of knowledge would encourage continuous innovation for the Islamic capital market at the global level. Dependant on Shariah principles, the innovations in sukuk are needed to achieve sustainability and growth in the global finance market while fulfilling the demands and needs of the investors and contributing back to the country's economy.

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