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Sukuk issuance and information asymmetry: Why do firms issue *sukuk*?☆

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ABSTRACT

This study investigates the factors that promote a bank borrower to issue *sukuk* rather than conventional debt security in Malaysia and Indonesia from 2000 to 2014. First, our empirical results show that a bank borrower is likely to approach the *sukuk* market as the funding size grows and if the firm is valued highly. Second, we find that under high information asymmetry, a firm with a high stock price and large funding demand prefers *sukuk* issuance to conventional debt. We conclude that firms use the *sukuk* market as an intermediate funding market when the funding demand is too large to borrow from banks and the information asymmetry is too high for them to approach the conventional debt market.

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1. Introduction

The number of debt security issuers is still small in the emerging economies. This directly suggests that most firms in countries undergoing economic development cannot choose desirable funding tools. Meanwhile, the number of Islamic bond (hereafter, *sukuk*) issuers dramatically expanded from 2001 onwards—the primary market total value in 2014 was USD 126 billion, 946 times that in 2000, although the total value temporarily fell to USD 60.7 billion in 2015. Reflecting this trend, recent studies discuss what causes a firm to approach the *sukuk* market (Mohamed et al., 2015; Azmat et al., 2014; Halim et al., 2016; Klein and Weill, 2016). The purpose of this study is to explore what encourages firms to resort to the *sukuk* issuance market in Malaysia and Indonesia. The major difference between our study and the existing literature is that our study hypotheses *sukuk* issuance as an intermediate funding methodology between bank borrowing and conventional debt issuance in terms of the relative funding size and the degree of information asymmetry of the firm. We contribute to the literature by showing unique evidence pertaining to how issuance determinants for *sukuk* and conventional debt are similar in some ways and different in others.

Existing studies (Udell and Berger, 1995; Boot, 2000; Elyasiani and Goldberg, 2004) consistently suggest that the lending relationships between banks and borrowers have positive effects on their operating performance. The hold-up and liquidity constraint hypotheses (Hoshi and Kashyap, 1990; Hoshi et al., 1991; Sharpe, 1990; Rajan, 1992) assert that a debt issuance firm is valued highly in the market, because it requires neither the partner bank's intervention nor financial liquidity rescue. Meanwhile, the market timing theory (Asquith and Mullins, 1986; Jung et al., 1996; Graham and Harvey, 2001; Hovakimian et al., 2001)

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asserts that a firm undervalued in the market prefers debt to equity issuance. This study first verifies that the bank–borrower relationship and firm market valuation are determinants of firm *sukuk* issuance. Specifically, we show that under high market valuation, a bank's borrower in Malaysia and Indonesia approaches the *sukuk* market as the funding size grows compared to the partner bank market capitalization size, consistent with the hold-up and liquidity constraint hypotheses.

Second, this study examines how firm information asymmetry is the key to differentiate *sukuk* issuance from conventional debt issuance. We suppose that the pecking order effect (Donaldson, 1961; Myers, 1984; Shyam-Sunder and Myers, 1999) has an explanatory power for the firm's *sukuk* issuance decision due to the existence of the unique structure of funding scheme, which mitigates information asymmetry between the issuer and investors. We hypothesize that a low degree of financial constraint of the firm commonly promotes *sukuk* and conventional debt issuance when the partner bank's commercial loan service cannot meet the too large funding demand. Alternatively, we specifically suppose that a firm chooses *sukuk* under a high degree of information asymmetry, and conventional debt under a low degree of information asymmetry, between firm insiders and outsiders. This is because the fixed tangible assets of the *sukuk* issuer's project, which is owned by a third party, cover the information costs.

The remainder of the paper is organized as follows. In the following section, we review the extant literature in this domain and introduce our hypotheses in Section 3. In Section 4, we present our empirical strategy and the data used to examine our hypotheses. Subsequently, in Sections 4 and 5, we discuss the results produced by our empirical models. Finally, in Section 6, we offer concluding remarks.

2. Literature review

Since the second half of the 2000s, related research has mainly focused on Islamic banking and has analyzed the similarities and differences between Islamic banking and conventional banking. For instance, Chong and Liu (2009) empirically analyze the Malaysian Islamic banking loan contract called *Musyarakah* and find that the investment rate of return for profit-sharing-based Islamic banking is statistically lower than conventional bank deposit rates. Meanwhile, TurkAriss (2010) focuses on the degree of competitiveness of Islamic banks. She studies Islamic banks and conventional banks in 13 countries for the period 2000 to 2006 and concludes that most Islamic bank borrowers are generally from the financial sector and that Islamic banks are less competitive than conventional commercial banks. Further, Ongena and Şendeniz-Yüncü (2011) analyze borrowers of Islamic banks. Their study compares Turkish Islamic bank borrowers and conventional bank borrowers and concludes that the former are young, emerging, and industrially less diversified firms, and that they transact with many banks. Abedifar et al. (2013) comprehensively survey the recent empirical literature on Islamic banking and conclude that Islamic banking has contributed to financial development in emerging economies.

In recent times, the number of studies comparing *sukuk* issuances with other financing techniques has increased. For instance, Godlewski et al. (2013, 2016) and Mohamed et al. (2015) empirically study the *sukuk* market using issuer data. Godlewski et al. (2013) compare the differences between cumulative abnormal returns of *sukuk* issuers and conventional bond issuers in Malaysia, and they conclude that the stock market negatively reacts to *sukuk* issuance announcements. Mohamed et al. (2015) also employ *sukuk* and conventional bond issuer data and conclude that firms choose *sukuk* issuance to optimize the cost and benefit balance for the issuers. Godlewski et al. (2016) investigate the relationship between the type of *sukuk* and the choice of *shari'a* board members and conclude that the nationality, term length, and reputation of *shari'a* board members mitigate the information asymmetry of the *sukuk* issuer. Maghyereh and Awartani (2016) and Naifar et al. (2016) study the relationship between *sukuk* yields and stock market volatility and its transmission mechanism. They conclude that the relationship is asymmetric and the stock market volatility influences *sukuk* yield, but the *sukuk* market does not influence the condition of the stock market. Halim et al. (2016) and Klein and Weill (2016) also study the relationship between the degree of information asymmetry of the issuer and *sukuk* issuance. They show evidence that the higher the degree of information asymmetry, the more frequently the firm issues *sukuk*.

In the case of conventional debt issuance studies, on the other hand, a body of research addresses the relationship between a firm's debt issuance and its lending relationship with the partner bank. The hold-up hypothesis (Sharpe, 1990; Rajan, 1992) asserts that a bank often intervenes in the low profitability projects of its partner borrowers. Therefore, a firm that chooses debt issuance is highly profitable if it does not require any future project interventions by the partner bank. Similarly, Hoshi and Kashyap (1990), Hoshi et al. (1991) and Bolton and Freixas (2000) conclude that a borrower of high creditworthiness prefers debt issuance to bank borrowing. This is because although the choice may force the issuer to liquidate the firm or undergo reconstruction proceedings in the future when facing a liquidity crunch, debt issuance enables large funding size, lower interest rate, and no collaterals. Bolton and Freixas (2008) assert that bank borrowers in emerging economies often witness a quick growth in funding demand and accordingly prefer debt issuance. This is because the funding choice saves the bank from the capital requirement restrictions.

Many studies also focus on the choice between conventional debt and equity issuance. As Ming et al. (2012) denote, the pecking order theory and timing theory are two major streams of firm security issuance theory. The pecking order theory asserts that firm managers are better informed than external investors (Donaldson, 1961; Myers, 1984; Shyam-Sunder and Myers, 1999). This theory stipulates that outside investors require better information when the firm is funded by equity issuance. Myers and Majluf (1984) and a number of other researchers support the idea. However, certain scholars do not support the pecking order theory. Fama and French (2005) conclude that more than 50% of U.S. firms violate the pecking order theory. Lemmon and Zender (2010) also find that debt is apparently preferable to equity financing in the absence of debt capacity concerns.

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