Review of Financial Economics 31 (2016) 26–33

Contents lists available at ScienceDirect

Review of Financial Economics

journal homepage: www.elsevier.com/locate/rfe

Why do companies issue *sukuk*?

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ARTICLE INFO

Available online 17 May 2016

JEL classification:
G14
P51

Keywords:
Financial instruments
Islamic finance
Debt issuance
Emerging countries

ABSTRACT

This paper investigates the determinants for firms to choose *sukuk* over conventional bond. We investigate the potential impact of information asymmetries through moral hazard and adverse selection to explain why firms prefer using *sukuk*. We perform logit regressions of the choice of debt type to determine which characteristics lead a firm to issue a *sukuk* rather than a bond. We use a dataset of *sukuk* and conventional bond issuances in Malaysia from 2004 to 2013. We find evidence of the influence of information asymmetries and adverse selection on the choice of the *sukuk* market.

1. Introduction

Islamic finance has considerably expanded with an increase of Islamic financial assets from $150bn in the mid-1990's to $1,400bn at the end of 2015 (KFUPM, 2016). The market of *sukuk*, the Islamic equivalent of bonds, itself gathers approximately $270bn, which represents 15% of Islamic total assets. This market is essentially rooted in emerging countries even if the UK and Luxembourg issued sovereign *sukuk* in 2014.

Islamic finance is a compartment of finance that complies with prescriptions of Islamic law, namely *sharia*. The transactions are based on licit Muslim contracts in the sense that they are compliant with the *sharia* requirements. Several characteristics distinguish Islamic finance from conventional finance, and so *sukuk* from bonds. First, interest defined as ex-ante required rate of return on a capital is not allowed, so the return of *sukuk* should stem from the profitability of its underlying assets. Second, some sectors are also forbidden because they are not compliant with *sharia*, mainly porcine, alcohol, pornography and weapon industries.[1] Third, two positive principles shape Islamic finance and *sukuk*: profit and losses must be shared between contracting parties, and every transaction must be backed on real and lawful assets. This last requirement leads to the use of special purpose vehicle (SPV) to issue *sukuk*.

Sharia requirements lead to specific *sukuk* features compared to conventional bonds. Thus, even if these two types of instruments share the common purpose to finance companies through debt, they can be chosen for different reasons by companies.

We can then wonder why some companies choose *sukuk* instead of bond for their financings. Our aim in this paper is to investigate the determinants of the choice of a *sukuk* over a conventional bond. To this end, we employ a dataset of *sukuk* and bond issuances in Malaysia for the period 2004–2013. Malaysia provides the largest corporate *sukuk* market in the world and as such represents the optimal country to perform such analysis. In addition, this country has developed a liquid bond markets, both for conventional bonds and for *sukuk*. We test two hypotheses to explain the choice for *sukuk*. Both hypotheses stem from the specific structuration of this security which generates information asymmetries.

First, firms with greater information asymmetries can favour the choice for *sukuk* over bonds because *sukuk* lead to a less efficient monitoring of shareholders and management than bonds. The use of a SPV may foster moral hazard issues in two ways. On one hand, shareholders may be tempted to encapsulate the least performing projects of the firm into a remote SPV without suffering the consequences from the investors. On the other hand, the *sukuk* structuration does not align the interests of the management and the shareholders (Jensen & Meckling, 1976) and does not prevent retention of free cash-flows (Jensen, 1986). Overall, *sukuk* may be chosen rather than bonds by firms with greater information asymmetries to prevent an effective market monitoring.

Second, an adverse selection mechanism due to the specific *sukuk* structuration can favour the choice of *sukuk* from companies in bad financial shape. Indeed, firms with less performing projects may be tempted to

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[1] See for instance the rules of the Dow Jones Islamic Index (http://www.djindexes.com/islamicmarket).

http://dx.doi.org/10.1016/j.rfe.2016.05.003
1058-3300/

put them in a SPV, outside of the balance sheet. The *sukuk* market would then be characterized by an adverse selection scheme. This effect would be reinforced by the moral hazard issues of the management and the shareholders. Issuing on the *sukuk* market would then consist in a negative signal for market, as suggested by Godlewski, Turk-Ariss, and Weill (2013).

Surprisingly no paper has ever investigated the determinants of choice between *sukuk* and conventional bond. We therefore contribute to the burgeoning literature on *sukuk*. We extend two empirical works, which are related to our study. Azmat, Skully, and Brown (2014) examine the determinants of choice between different types of *sukuk* but fall short of comparing them with conventional bonds. Godlewski et al. (2013) investigate the stock market reaction to *sukuk* issuance relative to bond issuance in Malaysia, and test the hypothesis that stock market investors can have negative presumptions on *sukuk* use by issuing firms.

The rest of the paper is organized as follows. Section 2 presents the *sukuk* market and the existing literature. Section 3 develops the tested determinants of the choice of a *sukuk*. Section 4 describes data and methodology. Section 5 displays the results, while Section 6 concludes.

2. Background

In this section we first present what distinguishes *sukuk* from conventional bonds and the recent evolution of *sukuk* markets. We then review the empirical literature on *sukuk*.

2.1. What are sukuk?

Sukuk consist in a specific class of *sharia*-compliant financial instruments which can be issued both by sovereign entities and firms. It combines characteristics of conventional bonds and stocks.

On one hand, *sukuk* can be considered as the Islamic equivalent of bonds because they share several similarities with bonds. Like bonds, they have a nominal value, a maturity date, a rate (called a margin) and provide a regular stream of cash-flows to investors including capital refunding at the end. As a consequence, several scholars consider that differences between *sukuk* and conventional bonds are mainly cosmetic (e.g. Miller, Challoner, & Atta, 2007 and Wilson, 2008).

On the other hand, some major features distinguish *sukuk* with conventional bonds. *Sukuk* can be better defined as tradable certificates of ownership that give the right of a stream of revenue from an investment project. It is the reason why they share some common features with capital-like instruments.

First, their structuring is strongly different from conventional bonds. Because Islamic finance requires each commercial transaction to be backed by real assets, *sukuk* need to be structured with a special purpose vehicle (SPV). The SPV buys the underlying assets of the investment project to the firm by raising funds from investors that are entitled with certificates of ownership. These certificates provide regular stream of cash-flows and a final capital refund. The project is managed by the issuer who can buy the underlying assets back.

Second, depending on the way the *sukuk* cash-flows are generated, it consists more in a debt or in a capital instrument. *Sukuk* can be of three types: debt-like, partnerships or a mix of both. In either case, assets are encapsulated in a SPV and constitute in the legal basis of the contract.

In the first case, the asset-based *sukuk* are structured with an Islamic equivalent of a credit contract. *Sukuk* can have the form of a cost-plus sale (*murabaha*), a prepayment contract (*salam*), an undertaking contract (*istisna*) or a leasing (*ijara*). For such *sukuk* type, the firm pays the investors, as it is the case for conventional bonds. However, these payments are channelled through the SPV. In the second case, the *sukuk* is backed by its own assets and relies on an Islamic partnership contract (*murabaha* or *musharaka*). In that case, the underlying project and the assets owned by the SPV generate the revenues to pay investors and not the issuer itself.

The type of *sukuk* has three important consequences. First, an asset-based *sukuk* will provide known cash-flows, uncorrelated with the project performance. Even if some assets are needed to base the operation on real assets (a mandatory condition for debt contracts in Islamic finance), the issuer will pay the coupons. The margin is defined ex-ante and often mimics interest, to the extent of being often indexed on conventional interbank rates.

Second and consequently, a debt-like *sukuk* will transfer the credit risk on the borrower. If the firm misses a payment, the *sukuk* is in default and it is technically the issuer's liability to refund investors. However van Wijnbergen and Zaheer (2013) point out that the complex structuration of *sukuk* makes uncertain the default process and reinforces the default cost.

Last, the refunding of the capital in a debt-like *sukuk* is defined at the beginning, whatever the real value of the asset is. In this way, debt-like *sukuk* are quite similar to bonds, an assessment already made by Wilson (2008) and put forward by rating agencies which evaluate *sukuk* in accordance with issuer's creditworthiness. Thus, in the case of asset-based *sukuk*, it is the issuer performance and reliability that will determine the payments and the credit risk of the *sukuk*.

On the contrary, partnership *sukuk* strongly rely on the performance of the assets that are used for their structuring. Their revenue and the refunding of the capital cannot be guaranteed by the issuer and depend on the profitability of the underlying assets and on market condition for their selling (AAOIFI, 2008). In this case, a *sukuk* is much closer to an equity instrument than a debt instrument. The default risk and the profitability are not determined by the firm characteristics but by the SPV itself, even if the firm usually secured the *sukuk*.

Moreover, if the revenues are theoretically variable, they can actually be composed of a fixed margin and a variable part smoothed with reserves accounts, in order to provide a foreseeable rate. In practice, due to these constraints, the *sukuk* market consists mainly of debt-like instruments (88% of the issuances from 1995 to 2015) (KFUPM, 2016).

According to KFUPM (2016), there has been a total of 887 billion $ of *sukuk* issued worldwide from 1995 to 2015, with tremendous year-to-year growth around 27.1%. This amount consists mostly in corporate *sukuk* (60%). Sovereign *sukuk* total 40% of the issuances. On 2015, roughly 80 billion $ of new *sukuk* have been issued. According to Kuwait Finance House (2014), the median maturity of the issuances is approximately one year, with 10% of *sukuk* issued with a maturity longer than 10 years. Malaysia marshals the greatest part of *sukuk* industry, with 86.8% of the issuances from 1995 to 2015. The government of Malaysia has taken several steps to promote Islamic finance and *sukuk* market. For instance, taxation rules for *sukuk* have been aligned with those of conventional bonds and some tax incentives have been established to facilitate the development of Islamic markets (Malaysian Institute of Accountants, 2012). The Securities Commission of Malaysia implemented two Capital Market Plans in the recent to promote Islamic finance (SC Malaysia, 2011). Several public structures have been implemented in order to enhance the attractiveness of Malaysian Islamic market, like the Malaysian Islamic Financial Centre (MIFC) or the Islamic Financial Services Board (IFSB). Last, by issuing the first sovereign *sukuk* in 2002 and then issuing regular sovereign *sukuk*, the Malaysian government commits to develop a liquid Islamic sovereign yield curve (Bank Negara Malaysia, 2007).

Malaysia managed to develop both bond market and *sukuk* market, even if the *sukuk* outstanding amount still represents only 51.4% of the bonds outstanding amount at the end of 2014 spring semester.[2]

As mentioned above, the *sukuk* market in Malaysia is characterized by an overwhelming amount of debt-like *sukuk* too. According to the

[2] Information provided by the Securities Commission website: http://www.sc.com.my/data-statistics/islamic-capital-market-statistics. Last view 29/01/2015.