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Are Islamic bonds different from conventional bonds? International evidence from capital market tests

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Abstract

Islamic bonds (Sukuk) emerged as an innovative capital market instrument over the last decade. This paper investigates the impact of conventional bonds and Sukuk announcement on shareholder wealth and their determinants using 79 Sukuks and 87 conventional bonds over the period of 2004–2012 in six developed Islamic financial market. The overall time frame is divided into three parts, 2004–2006 (before crisis); 2007–2009 (during crisis) and 2010–2012 (after crisis). It is revealed that the market reaction is negative for the announcements of Sukuk before and during 2007 global financial crisis. On the other hand market reaction is positive for announcement of conventional bond before the crisis period and negative during and after crisis periods. The size of bond offering appears to have a negative impact on the cumulative abnormal return in case of Sukuk and positive in case of conventional bond.

JEL classification: G14; G31; G32

Keywords: Bond; Sukuk; Abnormal return; Capital structure

1. Introduction

Islamic debt instruments commonly referred to as Sukuk.[2] Sukuk is one of the significant Islamic Shariah compliant financial instruments which provide an alternative source of financing especially for the giant corporate and sovereign entities compared to the conventional bonds. Sukuk is an innovative debt security which is similar to the conventional bond with respect to cash flow and risk. The last decade was the spectator of the unprecedented proliferation for Sukuk especially before the global financial crisis. Sukuk had emerged as one of the important components of global Islamic Financial System. Over the recent past years, the Sukuk market has witnessed approximately 10%–15% growth rate to reach US$ 170 billion outstanding portfolio at the end of 3rd quarter in 2011 (Global Sukuk Report, 2011). It contributes approximately 14.3% of the global Islamic finance asset.

The emergence of the Islamic banking and finance industry in modern economies, particularly in the Arab Gulf and some Southeast Asian states reflects an attempt to create a semi-independent financial system under the prevailing system. This feature has also characterized the creation of the Islamic capital markets within the prevailing conventional capital markets. One incontrovertible fact about Sukuk and bonds is

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[1] Tel.: +60 3 89248279; fax: +60 3 89248019.
[2] *Sukuk* is an Arabic term for the plural of '*suk*', which means certificate. Iqbal and Mirakhor (2007) defined *Sukuk* as participation rights in the underlying assets. Based on this definition, shares, notes, unit trust and bonds are all Sukuk. However, there is a great tendency among practitioners to use *Sukuk* interchangeably with bond.

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their existence in the same markets albeit with separate regulations relating to Shariah compliance. Apart from the fundamental Shariah concepts that underlie the different structures of Sukuk, the execution of the contracts is generally patterned after conventional bonds (Cakir & Raei, 2007). This does not undermine the usual controversy and myths surrounding the differences between Sukuk and conventional bonds. While Miller, Challoner, and Atta (2007) believe Sukuk and their returns mimic conventional bonds, Cakir and Raei (2007) argue that Sukuk are different from bonds, especially when one considers the diversification advantages which reduce the risk of portfolio.

Another major difference between Sukuk and conventional bonds is asset ownership which is borne out of the general structures of Islamic finance products. To a large extent, Sukuk holders own part of the underlying assets in any Sukuk transaction depending on the extent of their investment which determines the share they are entitled to. On the other hand, the nature of conventional bonds does not allow such type of ownership since the securities are considered debt obligations. The bonds are merely debt obligations issued to the bond holders by the issuer as a proof of the existence of a debt. No ownership in the business, joint venture or project is conferred on the bond holder. Consequently, while Sukuk represents a share in the project, business or joint venture, the conventional bonds merely represent a share in the total debt (Jamaldeen, 2012).

The recent controversy over whether some Sukuk actually comply with the precepts of Shariah suggests that Sukuk are generally structured along conventional rules of asset securitization. This raises the question of whether these innovative financial instruments are really all that different from conventional bonds. Wilson (2008) argues that issuers make special efforts to render Sukuk identical to conventional securities so unfamiliar investors can assess the risk of these new investments. Such Sukuk essentially mirror conventional securities, defeating the notion of product innovation in Islamic finance industry.

These concerns are also backed by renowned Shariah scholars. According to the President of the AAOIFI Shariah Council, Mohammad Taqi Usmani, current practices of issuing Sukuk replicate the structure of conventional bonds in terms of lack of ownership, right to a fixed return, and the guarantee of repayment of principal making most Sukuk un-Islamic. Usmani (2007) argues against seeking international bond ratings, since Sukuk can be rated by the recently established regional ratings agency (like Rating Agency Malaysia), if needed and Islamic banks should stand ready to endorse the acceptability of Sukuk.

Even with these controversies surrounding the issuance of Sukuk, Sukuk have witnessed strong surge in the issuance in Malaysia and Gulf Co-operation Council countries, there is strong evidence on Europe, Japan and Korea patronizing Sukuk in their respective countries. The continual growth of Sukuk has raised question whether Sukuk can play the role of an alternative source of financing which might replace the conventional bond. This study will give us the opportunity to compare between Sukuk and conventional bond with respect to market perception regarding these two alternative sources of financing.

The increasing use of Sukuk to raise capital is proven to have a positive effect on the Islamic capital market and overall the fund management industry, but its effect on shareholders' wealth is unclear especially during volatile global financial market. This is the first time the wealth effect of Sukuk issue announcement will be compared to that of conventional bond issue announcement considering three distinct period of time (before the global financial crisis, during the global financial crisis and after the global financial crisis). As the global financial crisis of 2007–2008 changed the whole dynamics of the financial sector in the world, this paper will try to explore contrasting difference between the wealth effects of Sukuk and conventional bond announcements surrounding the crisis period. Thus, the findings of paper will provide a comparative analysis of Sukuk and conventional bonds based on the market's sensitivity of these alternative financing instruments.

The findings of the paper will also try to resolve some of the myths surrounding the differences between Sukuk and conventional bonds. There is on-going discussion on whether Sukuk are different from conventional bonds. Cakir and Raei (2007) claim that Sukuk are different from bonds since they have diversification advantages especially of risk reduction when added to a basket of fixed income securities but others like Miller et al. (2007) and Wilson (2008) take an opposite stand to show that Sukuk returns are structured to imitate features of conventional bond. To overcome this conflicting stand we analysis stock market reaction to address this unsolved puzzle.

The remainder of the paper is organized as follows. Section 2 discusses the related literature and the theoretical framework guiding the study. Section 3 provides the sample description and research methodology adopted to achieve the objectives of the study. Section 4 discusses the findings and finally paper is concluded in Section 5.

2. Literature review

It has been documented in Islamic capital market literature that Sukuk serve as a vital tool for resource mobilization and a key instrument for the development of Islamic financial industry (Jobst, Kunzel, Mills, & Sy, 2008; Wilson, 2008). But very few studies empirically focus on their specific characteristics or stock market reactions to their issuance. Jobst et al. (2008) in their seminal paper summarizes some of the issues encompassing the Sukuk market. They advocate that, despite the global financial crisis, there is still a strong demand from both Islamic countries and conventional financial institutions for Shariah compliant securities like Sukuk.

Sukuks are also criticized on the precepts that they are commonly structured along similar lines of asset securitization as done in conventional finance thus raising the doubt over the uniqueness of Sukuk as innovative financial instruments. This notion is further supported by Wilson (2008) who argues that issuers apply special attention to issue those Sukuk which are