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Issuer's choice of Islamic bond type



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ABSTRACT

This paper analyses factors affecting an issuer's choice of Islamic bond structure as compared with conventional financial instruments. This choice is considered in the context of issuer firm variables, the 2008 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFIs) Islamic bond recommendations, and Shariah advisor effect in relation to Islamic instruments. A sample of Malaysian Islamic bonds is analysed using ordered probit model techniques. The results suggest that there are some significant differences between Islamic and conventional bond issuer's choice determinants which can be attributed to characteristics specific to Islamic bonds. For instance unlike conventional bonds, the stock valuation of the issuer did not impact debt–equity targets with Islamic joint venture (IJV) bond issuance. Other results from issuer firm characteristics were mixed and suggest that IJV bonds have little in common with equity and issuers should concentrate on a bond's security and seniority as with conventional bonds, rather than their Islamic structure. Secured against real asset (SARA) bonds were found not to always represent ownership of the underlying asset. AAOIFIs reported concerns in 2008 over Shariah quality of IJV bonds appear to have led to an aversion of IJV bond issuance. Finally, Shariah committees as opposed to individual Shariah advisors demonstrated an aversion to IJV bond issuance.

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1. Introduction

The factors that affect an issuer's choice of different financial instruments have been widely researched. Decisions like issuing debt as opposed to equity or secured rather than unsecured bonds have been

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attributed to different combinations of firm specific variables such as debt and profitability ratios (Julio et al., 2008). In addition, those characteristics unique to each instrument such as security, seniority, and tangibility of the assets may also have a significant impact on this decision as well as industry specific and macroeconomic factors.

The unique characteristics of Islamic bonds may further affect the issuer's choice. One difference, for example, is that secured against real asset (SARA) Islamic bonds have entitlement to actual ownership of the underlying asset rather than just a first charge.³ This means that SARA bonds are more secure than their conventional counterparts. In contrast, Islamic joint venture (IJV) bonds have more similarities with equity than debt. The prior literature has not investigated the impact that this wider range of Islamic bond characteristics may have on an issuer's debt selection. This gap motivates us to question whether the factors that affect an issuer's choice of Islamic bond are the same as for conventional bonds.

This paper analyses the determinants of the issuers' bond preference for 456 Malaysian Islamic bonds. The impact of firm specific variables, specific events (such as the 2008 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recommendations) and specific Islamic instrument characteristics (such as Shariah advisor effect) is analysed. The results show that some firm specific variables affect issuer's choice in a conventional bond like manner but others impact it differently. The findings suggest that both specific events and Islamic instrument characteristics are significant determinants of the issuer's decision. For example, the results show that in the aftermath of 2008 AAOIFI recommendations, issuer's aversion for IJV bonds increased. Also it is found that IJV bonds are less likely to be approved by Shariah committees.

The findings have implications for regulators and Islamic bond issuers. For regulators, it is suggested that they further support Shariah harmonization for the industry to prosper. For issuers, the results imply that firm specific variables should affect their choice of Islamic bond type not unlike that of conventional debt. The rest of the paper is organized as follows. Section 2 considers the unique features of Islamic bond structures. Section 3 provides the literature review, with data described in Section 4. Section 5 presents the methodology, Section 6 the results and Section 7 concludes the paper.

2. Islamic capital market features

This section considers the characteristics of three main types of Islamic bonds: Islamic joint venture (IJV), secured against real asset (SARA) bonds and debt bonds,⁴ as well as the role of Shariah advisors and the AAOIFI (2008) updated Shariah standards.

2.1. IJV bonds

IJV bonds (Musharakah/Mudarabah Sukuk) have both debt and equity characteristics. Their holders become part owners of the issuer or more commonly of a specific project. If successful, IJV bond holders share in the profits and receive periodic payments depending on a pre-agreed percentage. They must also bear any loss according to their investment proportion on maturity; the issuer can then buy back the IJV bonds but at their market price rather than face value (Usmani, 2006). Furthermore on bankruptcy, IJV bond holders rank equally with shareholders rather than normal creditors, but unlike shareholders have no voting rights.

2.2. SARA bonds

Secured against real asset (SARA) bonds (Ijarah Sukuk) are typically structured using a special purpose vehicle (SPV). While it may be created by the issuer, the SPV is legally separate and considered a bankruptcy remote entity just as in conventional structured finance. The originator sells the SPV some specific assets which are agreed to and then leased back at a periodic rental rate and then repurchased at a certain price and a certain date. The SPV uses this set of agreements to support a SARA bond issue and uses the issue's proceeds to pay the issuer for the assets. The SPV collects the rental payments and pays them to the bond holders as well as on maturity, the face value. SARA bonds differ from conventional ones in that

³ A holder with a first charge over a specific asset will be entitled to be the first in line to be repaid first from the proceeds of its sale in case of default.

⁴ AAOIFI has standards for more than 14 different types of Islamic bonds but the focus here is on the most popular.

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