A THEMATIC LITERATURE REVIEW ON *SUKUK*

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Abstract

Although there has been extensive research being done in the field of Islamic finance, literature on sukuk are inadequate. This paper intends to present a thematic review of this subject matter. Through a thematic and chronological review, this paper is divided into the following themes; the first two sections are general i.e. we begin with an overview on the structure and nature of a sukuk contract, and the theories that have been adopted in sukuk research. While the remaining sections are separated according to the type of research i.e. a comparison between sukuk and bonds and investors' perception of sukuk, and the impact of sukuk on economic growth. Besides providing a summary of the main points covered in current literature, this paper also highlight trends and issues on sukuk research and provide insight on limitation of current research as well as suggest future research directions.

Key Words: *Sukuk, Capital Market, Literature Review, Islamic Bond, Islamic finance*

A. Introduction

The Securities Commission Malaysia (2012) define *sukuk* as "*certificates of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts endorsed by the Shariah Advisory Council (SAC), but shall not include any agreement for a financing/ investment where the financier/ investor and customer/ investee are signatories to the agreement and where the financing/ investment of money is in the ordinary course of business of the financier/ investor, and any promissory note issued under the terms of such an agreement.*" In short, *sukuk* is a financial document evidencing the transfer of funds between investors and the *sukuk* issuer – in return for ownership and a share profits on/ from specified assets owned by the issuer.

Research on *sukuk* have divided the instrument into two (2) categories: exchange-based *sukuk* and partnership *sukuk*. Exchange-based *sukuk* are *sukuk* that involve a transfer of assets from the *sukuk* issuer to *sukuk* investors. While partnership *sukuk* are *sukuk* where *sukuk* investors inject funds into the issuing firm and become partners with the firm. In the first category, *sukuk* structures such as *murabahah*, *ijarah*, *bay' bithamanajil*, *musawamah* are used. Whereas in the second category, *sukuk* structures such as *mudharabah* and *musyarakah* are used.

The diverse selection of Islamic contracts that can be used to formulate a *sukuk* structure differentiates *sukuk* from conventional financial instruments. Unlike bonds, due to the nature of the underlying contract, each *sukuk* is designed differently and can be tailored specifically toward the needs and business structure of the issuer. However, very few studies have explored the contractual differences between *sukuk* structures and those that do focuses on individual contracts and answers the question of whether the instrument is Shariah-compliant (Razak, Saiti, & Dinç, 2019; Saripudin, Mohamad, Razif, Abdullah, & Rahman, 2012; Tariq, 2004)or whether it fulfils the requirement as stipulated by the Securities Commission Malaysia (SC) and/ or AAOIFI.

Hence this paper attempts to shed light on the evolution of literature in *sukuk*, beginning with the structure and nature of *sukuk*– focusing on the difference between the two categories of *sukuk*, exchange-based *sukuk* and partnership *sukuk* as well as the difference between *sukuk* and bonds. Other than that, this paper will also provide a summary of findings in relation to investors' perception of *sukuk* and the impact of *sukuk* on economic growth. This paper provides critical information for *sukuk* research and can be used as a reference point for future studies in Islamic capital market research.

A.1. Methodology

Due to the limited number of available literatures, this paper utilizes the snowball approach in collecting relevant literature on the subject matter. We begin by searching databases such as Scopus, Web of Science, and Google Scholar using the following keywords such as *sukuk*, partnership *sukuk*, exchange-based *sukuk*, *sukuk* structure, *sukuk* vs bonds and impact of *sukuk*.
Backward snowballing is used where we identify citations in a suitable paper to determine similar works on the subject matter (Wee & Banister, 2016). Hence only thirty (30) of selected papers which have been published in the past 13 years i.e. from 2007 until 2019are selected and arranged in a chronological order.

B. Literature Review: Structure and Nature of *Sukuk*

Depending on the type of firm issuing the *sukuk* – be it a parent/ holding company or a special-purpose vehicle (SPV) which was created specifically for the *sukuk* issuance, a *sukuk* contract would be drafted to specify the role of the *sukuk* issuer, the underlying contract used, the underlying asset supporting the financial obligation evidenced in the *sukuk* and the estimated profit rate (for exchange-based *sukuk*)/ profit sharing ratio (for partnership *sukuk*). There is a significant difference between how an exchange-based *sukuk* and partnership *sukuk* is managed as well as arising issues surrounding these two *sukuk* structures.

Table 1 Exchange-Based *Sukuk*vs Partnership *Sukuk*

	Exchange-Based *Sukuk*	**Partnership *Sukuk***
Role of Issuer	Depending on the contract, the issuer either sells or leases an asset to the *sukuk* investors and later may repurchase the asset from the investors. The purpose of the sale of asset is for fund-raising purposes only.	Depending on the nature of the contract, the issuer can be a partner or an agent to *sukuk* investors i.e. the investors form a partnership among themselves and appoint the issuer as their agent.
Underlying Contracts	*Murabahah*, *Ijarah*, *Bay' bithamanajil*, *Musawamah*, Bay' Salam, Istisna', *Tawarruq*, Bay' al-Inah	*Mudharabah*, *Musyarakah*
Underlying Asset	The underlying asset must be Shariah-compliant. It can be tangible and/or intangible and receivables can also be used as long as the receivables are established, certain and transacted on cash basis (on spot).	

<table>
<tr><td rowspan="2">Issues</td><td>The existence of asset-based sukuk instead of asset-backed sukuk.
An increasing number of sukuk defaults especially for asset-based sukuk.</td><td>The proliferation of agency issues in partnership contracts.
Guarantee of principal repayment.
Purchase of shares at nominal value instead of market value.</td></tr>
<tr><td colspan="2">Sukuk returns are benchmarked to interest or conventional bonds.
The use of debt as the underlying asset.
Lack of alternatives for the issuer and investor to manage exposure to liquidity, market, interest rate, and foreign-exchange risks.</td></tr>
</table>

Sources: Adopted and compiled from Howladar(2009), Muhammad Al-Amine (2008), Securities Commission Malaysia (2012) and Usmani (2008)

Early literature on *sukuk* structures have highlighted a number of issues in *sukuk* structures – criticising that the existence of several mechanisms has turned *sukuk* similar to bonds. Hence, it would be prudent to begin with Usmani (2008) ruling on *sukuk*. According to Usmani, there exist three (3) mechanism in current *sukuk* structures that allow *sukuk* to bear similar resemblance to bonds:

Table 2Usmani's Ruling on *Sukuk*

Mechanism	Shariah Implication
Allowing the manager/ *sukuk* issuer to keep excess profits as an incentive for good investment	Majority jurists find it to be *makruh* due to ignorance on the exact value of the fee received by the *sukuk* issuer as agent to *sukuk* partners. However, a number of jurists allow for *tanazul* with the condition that the fee received by the *sukuk* issuer is known and it is pre-agreed between the *sukuk* issuer and investors that if profits received from the venture is beyond a certain percentage, the issuer may exclusively enjoy the excess profits.
Allowing the manager/ *sukuk* issuer to lend the value of shortfall if profits are less than expected amount.	The Prophet p.b.u.h. prohibited the practice linking sales to credit in a hadith narrated by Imam Malik and Abu Dawud and al-Tirmidhi.
Binding promise by manager/ *sukuk* issuer to purchase assets at face value at maturity	Commitment by the *sukuk* issuer to purchase *sukuk* assets at face value upon maturity regardless of the true value of the asset becomes capital guarantee by the *mudharib/ musyarik* to the investors and there is no justification for the commitment made by the *mudharib/ musyarik*.

These mechanisms are mainly used in *wakalah*, *mudharabah* and *musyarakah* *sukuk*. And although Usmani have strongly criticised the application of these mechanism in *sukuk*, it appears that they are still in use in a number of partnership and agency *sukuk* contracts today.

Muhammad Al-Amine (2008) has also provided several criticisms on existing *sukuk* structures. Some of the criticisms are in regards to the partnership structure of *musyarakah* and similar to what has been voiced out by Usmani (2008). However, there are additional criticisms such as:

(1) The use of guarantee in *ijarah sukuk*;
(2) The application of bay' al-Inah in *ijarah sukuk* i.e. sale and leaseback contract for the underlying assets;
(3) *Sukuk* pricing that are benchmarked to LIBOR;
(4) Lack of eligible underlying assets for *sukuk*; and
(5) Differences of opinion among the different school of thoughts may result in a contract that is frowned upon in one country such as *tawarruq* is accepted in another country.

For an in-depth examination on the permissibility of the mechanisms adopted in *sukuk*, Abdul Rahman & Hasan (2011),Hasan (2011) and Ellias, Haron, & Mohammed (2013)have provided a lengthy discourse on guarantee of capital, the application of *tanazul* in *musyarakah*, and other Shariah issues in *sukuk*. These authors have not only quoted classical scholars and Imams of the four main schools of thought, but also explained the different ways in which these mechanisms can be implemented and differentiated the application in which it is permissible compared to when it becomes non-permissible.

Later studies that focuses on the capital market and capital market instruments by Godlewski, Turk-Ariss, & Weill (2011), Lahsasna& Lin (2012)and including a more recent paper by Razak et al. (2019) continue to highlight similar concerns indicating that the mechanisms are still practiced and implemented in *sukuk*. These include fixed periodic returns over the *sukuk* and guarantee of principal for *mudharabah* and *musyarakah sukuk* and concerns over the true transfer of ownership of the underlying asset for *ijarah sukuk*.

C. Analysis: Theories Adopted in *Sukuk* Research

As far as we are aware, no specific theory has been developed for Islamic financial instruments. Existing studies in *sukuk* adopts investment theories such as capital structure irrelevance theory, trade-off theory, pecking order theory, signalling theory, and agency theory and tries to identify whether *sukuk* acts in a similar manner to debt or equity instruments.

A study by Haron & Ibrahim (2012) found that *sukuk* has a significant impact on the Malaysian bond market development and is employed by firms to manage and adjust towards their target capital structure. Based on the trade-off theory, both *sukuk* and conventional bond issuers exhibited a target optimizing behaviour; where *sukuk* issuers demonstrated a faster speed of adjustment compared to conventional bond issuers (Hanifa, Masih, & Bacha, 2014a).Unlike conventional bond issuers, where profitability was found to have a significant negative effect on conventional bond ratio, profitability was determined to be insignificantly related to *sukuk* ratio, indicating that *sukuk* financing is sought by issuers regardless of the availability of internal funds. Hanifa et al. (2014)also found *sukuk* ratio to be significant and positively affected by the firm's growth opportunity, consistent with pecking order predictions.

Meanwhile Alam, Hassan, and Haque (2013)have adopted the signalling theory in their study. They found that *sukuk* announcements result in a negative signal in the market. Based on their study, the authors concluded that weaker companies prefer to issue *sukuk*, specifically risk-sharing or partnership *sukuk* in order to minimize their loss in the event of failure while companies that expect to earn high returns prefer to issue bonds to maximize their returns in the event of success. However, a later study by Mahomed (2016)found both exchange-based and partnership *sukuk* emitted a positive signal before the global economic crisis. However, after the crisis, market reaction only remained positive for exchange-based *sukuk*. Although partnership *sukuk* emitted a negative signal after the crisis, the results were insignificant.

D. Discussions: Type of *Sukuk* Research

Sukuk research are mainly divided into three categories: (1) A comparison between *sukuk* and bonds; (2) Investors perception of *sukuk*; and (3) The impact of *sukuk* on economic growth.

D.1 Comparison between *Sukuk* and Bonds and Investors' Perception of *Sukuk*

Is *sukuk* a similar instrument to bonds? Godlewski, Turk-Ariss, & Weill (2011) in their paper posed a similar question. They quote Miller, Challoner and Atta (2007) who state that *sukuk* are structured to ensure an equivalent return to conventional bond, but that return is derived from an underlying asset rather than the obligation to pay interest. They also quote Wilson (2008) who opined that financiers design *sukuk* to be similar to conventional securities so unfamiliar investors are able to assess the risk of *sukuk* easily.

According to Usmani (2008), *sukuk* is different compared to both equity and debt instruments due to the following factors:

(1) Unlike bond or equity, a *sukuk* certificate represent ownership in a specific underlying asset;
(2) Depending on the underlying *sukuk* structure, *sukuk* holders may receive regular payments like bondholders or irregular payments like equity holders; and
(3) Like equity holders, *sukuk* holders are not guaranteed principal repayment at maturity.

This is supported by a number of authors who affirm *sukuk* as a different instrument compared to conventional bonds (Alam et al., 2013; Cakir & Raei, 2007; Godlewski, Turk-Ariss, & Weill, 2013; Hanifa, Masih, & Bacha, 2014b; Safari, 2013). However, a deeper investigation reveals contradictory findings – while a group of authors state *sukuk* as different, another group claim *sukuk* and bonds are the same. Among them is Howladar (2009)who states that current *sukuk* structures are similar to conventional fixed income instruments from a risk/ return perspective:

(1) Underlying assets have little or no bearing on the risk or performance of the *sukuk*;
(2) Majority of *sukuk* contracts do not transfer the ownership of the underlying assets to investors; and
(3) *Sukuk* returns and cash flows are not linked to the underlying assets.

To gain a better understanding on the matter, a compilation of selected literature comparing *sukuk* and bonds have been tabulated in the following table:

Table 3 Literature on *Sukuk*vs Bonds and Investors' Perception of *Sukuk*

Year	Title/ Author	Sample	Methodology	Findings
2007	*Sukuk* and their Contemporary Applications/ Usmani	-	Discussion Paper	Highlight criticisms in the current *sukuk* structure such as (1) The use of debt as the underlying asset in *sukuk* structures; (2) Fixed return to *sukuk* holders; and (3) Guarantee of principal.
2009	The Future of *Sukuk*: Substance over Form?/ Howladar	Selected *sukuk* contracts – Tamweel PJSC and East Cameron Partners L.P.	Commentary/ Case Study	Current *sukuk* structures are similar to conventional fixed income instruments from a risk/ return perspective: (1) Underlying assets have little or no bearing on the risk or performance of the *sukuk*; (2) Majority of *sukuk* contracts do not transfer the ownership of the underlying assets to investors; (3) *Sukuk* returns and cash flows are not linked to the underlying assets.
2011	Do Markets Perceive *Sukuk* and Conventional Bonds as Different Financing Instruments?/ Godlewski, Turk-Ariss,	Sample period between 2002 to 2009 encompassing 93 events for bonds and 77 events for *sukuk* from Malaysia.	Event study	Stock markets are able to distinguish between *sukuk* and bonds and recognises the two instruments as different. Hence, investor reaction to *sukuk* and bond announcements are

	and Weill			different.
2013	Compare and Contrast *Sukuk* (Islamic Bonds) with Conventional Bonds, Are They Compatible?/ Afshar	-	Qualitative Review/ Discussion Paper	Bonds and *sukuk* are different instruments that solve the same financial problem i.e. raising capital for entities. Both instruments are structured differently and *sukuk* should provide greater return and financial security compared to bonds.
2014	Daily Traders' and Institutional Investors' Wealth Effect upon *Sukuk* and Conventional Bond Announcements: A Case Study of Malaysian Firms Using Event-Study Methodology and Wavelet Analysis/ Hanifa, Masih and Bacha	Sample taken from the Malaysian stock market with 158 conventional bonds and 129 *sukuk* issuers between 2000 and 2003	Event Study and Wavelet Analysis	Market investors perceive *sukuk* and bonds as different financial instruments – firm value and shareholder wealth are affected differently upon the issuance announcement of *sukuk* and bonds.
2015	The (Little) Difference that Makes All the Difference between Islamic and Conventional Bonds/ Azmat, Skully, and Brown	Sample of 458 Islamic bonds from 83 issuers covering the period between 2002 to 2010 from Malaysia	Ordered Probit Analysis	There are very few differences between conventional and Islamic instruments other than in Islamic structural differences – in terms of structure, some Islamic instruments are cosmetically treated to give an illusion

				of difference.
2016	Does Innovation in *Sukuk* structure create Value? A study of post crisis *Sukuk* wealth effects in Malaysia/ Mahomed, Mohamad, and Ariff	The crisis period is identified empirically, using Bai-Perron (2003) multiple breakpoint analysis.	Event study methodology (Market Model) is used to determine market reaction and the wealth effect based on 24 *sukuk* events. Both parametric (BMP) & non-parametric (Rank) tests are used for max robustness. Scholes-Williams (1977) approach was applied to adjust for thin trading & the Kolari-Pynnonen (2010) test to remove cross-correlation effects.	The market distinguished between debt and equity based *sukuk* pre-crisis, supporting the conjecture that financial innovation creates value for shareholders. However, no net reaction is observed post-crisis irrespective of structure, indicating the market's indifference to *sukuk* against bonds, implying that *sukuk* in Malaysia is no longer perceived as a financial innovation.
2017	Do Regional and Global Uncertainty Factors Affect Differently the Conventional Bonds and *Sukuk*? New Evidence/ Naifar, Mroua, and Bahloul	*Sukuk* - Dow Jones *Sukuk* Index and Malaysian *Sukuk* Index. Bonds – Dow Jones Asia Bond Index and Malaysia Corporate Bond Index. Volatility – VIX Volatility Index. Global Economic Uncertainty – U.S. Economic Policy Uncertainty	Quantile Regression	*Sukuk* are different than conventional bonds in terms of co-movement with global and regional uncertainty factors and these two instruments are complementary and not substitutes.

		(EPU) Index. Data from Jan. 2010 until Dec. 2014.		

Based on the information gathered in the above table, we can surmise that existing studies that compares *sukuk* to bonds are divided into two (2) main camps:

(1) Those who study the underlying structure of *sukuk* (Afshar, 2013; Azmat et al., 2015; Usmani, 2008) find *sukuk* to be a similar instrument to bonds due to how the instrument is designed. Although dissimilarities may exist between the two instruments, those differences are small and may even be due to cosmetic enhancements to the underlying structure so as to distinguish *sukuk* from bonds; and

(2) Those who study market reaction and investors' wealth (Godlewski et al., 2011; Hanifa et al., 2014a; Howladar, 2009; Mahomed et al., 2016; Naifar et al., 2017) claim *sukuk* and bonds as different instruments. According to them, the market perceives both instruments as different, hence investors react differently to issuance notice of either instrument. Both instruments were also found to be affected differently by regional and global uncertainties which further reinforces the view that *sukuk* and bonds have dissimilar characteristics.

D.2 The Impact of *Sukuk* on Economic Growth

On a macroeconomic perspective, an increasing number of literatures have also investigated the impact of *sukuk* on economic growth.

Table 4 Literature on *Sukuk* and Economic Growth

Year	Title/ Author	Sample	Methodology	Findings
2011	Sustainability of *sukuk* and conventional bond during financial crisis: Malaysia's capital market/ Ahmad & Radzi	20 *sukuk* and bond issuance in Malaysia from the period 1990 to 2009.	Regression analysis.	*Sukuk* has a positive relationship with GDP, foreign exchange and international liquidity. The adverse impact of financial crisis on *sukuk* is lesser compared to bonds.
2017	How do sovereign *sukuk*impact on the economic growth of developing countries? An	Sovereign *sukuk* issuances in Malaysia and Saudi Arabia between 2002 to 2011.	Paired sample t-test on panel data comprising of economic, state financial and social	Sovereign *sukuk* issuances have a positive impact on the economic development of Malaysia and Saudi Arabia.

	analysis of the infrastructure sector/ Malikov		development indicators.	
2017	Impact of *sukuk* market development on Indonesian economic growth/ Mitsaliyandito, Arundina, & Kasri	Quarterly data of outstanding *sukuk* from 2009 – 2016.	VAR model and Granger causality test.	Domestic sovereign *sukuk* market has a positive influence on Indonesian GDP bigger than the corporate market.
2017	Does *sukuk* market development spur economic growth?/ Smaoui & Nechi	All *sukuk* issuing countries from the period 1995 – 2015.	System GMM	*Sukuk* market development is conducive to economic growth i.e. the development of *sukuk* market may have promoted financial inclusion by eliminating the negative effects of religious self-exclusion, which stimulates investment and economic growth.

Although the number of literatures are limited, *sukuk* has been found to have a positive impact on economic growth. It is foreseen that more studies should be conducted on the impact of *sukuk* on economic growth especially in Middle East and African countries where there has been an increase in *sukuk* issuances over the past few years.

E. Conclusion: Limitation of Current Research and Recommendation

This paper has provided a selection of literature that encompass different themes – investigation into the underlying structure and nature of *sukuk*, comparison between *sukuk* and its conventional counterpart i.e. bonds, investors' perception of *sukuk* i.e. do investors see *sukuk* as a similar instrument to bonds, adoption of finance theories into *sukuk* research and the impact of *sukuk* on economic growth.

In the beginning, *sukuk* literature was geared extensively towards qualitative research where scholars investigated the various mechanisms used in structuring *sukuk* and question the origin of those mechanisms. As the number of Shariah compliant instruments increased, studies in *sukuk* evolved into quantitative research and moved towards measuring the impact and performance of *sukuk* and comparing *sukuk* with bonds. There still exist many gaps in existing research for *sukuk*, among them are the impact of default *sukuk* on the *sukuk* issuer or the obligor and this can be quantified in many ways such as impact on shareholders' wealth, impact on firm share price as well as impact on the obligor's cash flow and risk. Another aspect that has yet to be explored is the introduction of new hybrid *sukuk* i.e. *sukuk* that consist of two or more underlying contracts such as *wakalah* and istisna', *musyarakah* and *ijarah* and many more. There is an increase in the use of hybrid *sukuk* especially in Malaysia and so far, there has yet to be a study investigating the performance, risk, and impact of hybrid *sukuk*.

As for limitation for current research on *sukuk*, it is evident that most *sukuk* research are mainly focused on *sukuk* issued in Malaysia, Indonesia and GCC countries. In recent times, we have seen *sukuk* being issued by financial centres such as Hong Kong and London and to our knowledge there are no research (both qualitative and quantitative) on *sukuk* issued by these financial centres.

In conclusion, it can be said that as the *sukuk* market grow and matures, there is still a need for research on current *sukuk* structures and its impact both on a macro and micro perspective. This paper has presented several important findings on *sukuk* and it is evident that there is a need for more research to be done on the *sukuk* instrument.

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