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Sukuk vs. conventional bonds: A stock market perspective ☆

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ABSTRACT

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The last decade witnessed a wide expansion of Islamic finance in Middle Eastern and Southeast Asian countries. *Sukuk* issues, which are Islamic financial instruments structured to replicate the cash flows of conventional bonds, have notably proliferated, fuelling the debate on the similarity between Islamic and conventional finance. Using an event study methodology on a sample of Malaysian listed companies, we investigate whether stock market investors react differently to the announcements of *sukuk* and conventional bond issues. We find that the stock market is neutral to announcements of conventional bond issues, but it reacts negatively to announcements of *sukuk* issues. We attribute this finding to the excess demand for Islamic investment certificates and to an adverse selection mechanism that favors *sukuk* issuance by lower-quality debtor companies. *Journal of Comparative Economics* **41** (3) (2013) 745–761. EM Strasbourg Business School, University of Strasbourg, Strasbourg, France; Lebanese American University, Beirut, Lebanon; University of Haute Alsace & EM Strasbourg Business School, Mulhouse, France.

1. Introduction

The past decade witnessed an unprecedented expansion in Islamic finance, including a notable widening of operations of Islamic banks and extensive issuance of *sukuk*, investment certificates that comply with Islam's *Shari'a* legal code.[1] Recent figures indicate that Islamic banks operating in over 75 countries have total assets of about $300 billion and enjoy an annual growth rate exceeding 15% (Chong and Liu, 2009). The *Financial Times* estimates the value of industry overall in excess of $1 trillion (Financial Times Special Report, 2010). Much of this expansion has been fuelled by *sukuk* issuance. Just as Islamic banks provide an alternative mode of financing compared to conventional banking, *sukuk* are similar in structure to conventional bonds but allow sovereign and corporate entities to raise funds in capital markets in conformance with *Shari'a* principles.

For *sukuk* to be *Shari'a*-compliant, however, three criteria must be met: (1) the certificates must represent ownership in tangible assets, usufruct or services of revenue-generating firms; (2) payments to investors should come from after-tax

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[1] See Beck et al. (2013) for a broad analysis of Islamic banks. Recent papers on Islamic banks include Abedifar et al. (2013) and Baele et al. (2012) on the relationship between Islamic banking and risk, and Zaheer et al. (2011) on monetary policy issues related to Islamic banks.

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profits; and (3) the value repaid at maturity should reflect the current market price of the underlying asset – not the original amount invested. Recently, a debate was ignited after a leading *Shari'a* scholar announced that most *sukuk* do not comply with *Shari'a* because they are in violation with at least one of the three principles, effectively making them no different from conventional bonds.[2] Similarly, Miller et al. (2007) and Wilson (2008) contend that *sukuk* instruments are generally structured along Western rules of securitization and do not constitute financial innovation. In contrast, Cakir and Raei (2007) offer the counterargument that *sukuk* offer unique risk-reduction benefits when added to a portfolio of fixed income securities and are thus distinct from conventional bonds.

This study goes to the heart of the debate over whether *sukuk* are financing instruments that mirror conventional bonds or whether they have a distinct character of their own. We put aside theoretical and structural differences and similarities between *sukuk* and conventional bonds and investigate whether stock market participants themselves distinguish between these two types of financial instruments. We use an event methodology to examine whether announcements of *sukuk* and conventional bonds lead to significant abnormal returns for the different types of issuers. While the issuance of *sukuk* is ostensibly motivated by religious principles, we ask whether extrinsic factors such as access to a new class of investors might also be involved in the issuance of these securities.

Two opposing hypotheses may predict the stock market reaction to *sukuk* and conventional bonds issues. On the one hand, we can expect no significant difference between the announcement effects of both types of issues, following the opinion that these financial products are similar and do not differ in practice. Under this hypothesis, financial markets participants would consider them as totally comparable instruments and they make no difference between these issues.

On the other hand, stock markets may react more negatively to the issuance of *sukuk* than to conventional bonds if investors consider that the selling of *sukuk* represents a negative signal about the quality of the borrower. Two reasons motivate this hypothesis. First, adverse selection may favor the issuance of profit-and-loss investment certificates (*sukuk*) over conventional interest-based bonds by borrowers with the lowest return expectations. Second, such borrowers find it easier to sell *sukuk* because of the excess demand for these instruments from Islamic banks and other Islamic financial institutions.

To analyze the stock market reaction to *sukuk* and conventional bond issuance, we consider a sample of Malaysian listed companies that issued conventional bonds and *sukuk* during the period 2002–2009. For our purposes, Malaysia is ideal as it is by far the most active market in terms of corporate *sukuk* issues. The volume of *sukuk* issued in Malaysia alone in 2007 was $28.1 billion, compared to $19 billion for all GCC countries (Ernst and Young, 2009). Furthermore, Malaysia dominates the global corporate *sukuk* market with 75% share of total corporate *sukuk* over the period January 2004–June 2007. Malaysian *sukuk* are also valuable for the purposes of this study as they represent about half of the total stock of Malaysian corporate bonds (Jobst et al., 2008), i.e. they are not limited to a small portion of the disintermediated financing for companies.[3]

We find that investors react differently to the issuance of *sukuk* and conventional bonds. Conventional bond issues lead to no significant stock market reaction, whereas *sukuk* issues associate with a significant negative stock market reaction.

Our study is topical in light of the recent expansion of *sukuk*, broadening a fairly thin body of research on these novel securities. Existing work on the emergence of *sukuk* appears in the context of overviews of Islamic finance (e.g. Iqbal and Mirakhor, 2007; Visser, 2009), and only few studies investigate their evolution or specific characteristics (e.g. Jobst, 2007; Jobst et al., 2008).

The remainder of the paper is structured as follows. In Section 2, we provide an overview of *sukuk* and a literature survey. We present the data and methodology in Section 3. In Section 4, we display our results, and we discuss the findings in section 5. Section 6 concludes.

2. An overview of *sukuk*

This section starts with a discussion of what distinguishes *sukuk* from conventional bonds and recent market developments. We review the prospects and challenges facing *sukuk*, and conclude by addressing our main research question as to whether markets see *sukuk* as distinct from conventional bonds.

2.1. What are sukuk?

Islamic capital markets have witnessed the issuance of *Shari'a*-compliant financial instruments known as *sukuk*.[4] *Sukuk* investments represent a distinct class of securities issued by sovereign and corporate entities. They are investment certificates with both bond and stock-like features issued to finance trade or the production of tangible assets. Like bonds, *sukuk* have a maturity date and holders are entitled to a regular stream of income over the life of the *sukuk* along with a final balloon payment at maturity. However, *sukuk* are asset-based rather than asset-backed securities, with the underlying asset being necessarily *Shari'a*-compliant in both nature and use. The eligibility of *sukuk* rests on identifying an existing or a well-defined asset, service, or project capable of being certified by a third party, and for which ownership can be recorded in some form. *Sukuk* holders

[2] Following the scholar's pronouncement on lack of *Shari'a* compliance of *sukuk*, issuance activity declined in 2007 to later pick up toward the end of the year.

[3] It is important to mention *sukuk* from Malaysia differ from those that are sold in the GCC region, and that their acceptability and tradability might not be consistent across the two Islamic hubs.

[4] The Arabic term *sukuk* is a plural form of *Sakk*, which derives from a Persian term meaning "to strike one's seal on a document" (McMillen, 2007). Adam (2006) notes that the term was introduced in Medieval Europe, eventually becoming our modern word "Cheque."