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What explains corporate *sukuk* primary market spreads?

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ABSTRACT

This study investigates the determining factors of international corporate *sukuk* pricing in the primary market for the period of 2004–2015. We present novel evidence for a unique data set covering all 63 international corporate *sukuk* issuances consisting of both a fixed margin rating as well a credit rating score. Our cross-sectional analysis indicates that both credit rating and maturity are significant factors which reduce issue spreads, whereas *sukuk* margin rating increases issue spreads. More prominently, *Shari'ah* scholar reputation and the type of *sukuk* are not statistically significant factors in the explanation of the issue spread. Our results are comparable with determinants of conventional bond pricing, and our findings further confirm existing *sukuk* market practices.

1. Introduction

Islamic finance is an ethically and religiously established alternative financial method aimed at supporting the real economy. The focal characteristic feature of Islamic finance lies in its compliance with Islamic legal or *Shari'ah* rules, which includes the prohibition of interest and gambling as well as speculation and excessive uncertainty and essentialising profit-and-loss sharing and risk sharing financing (Asutay, 2015). Even though, in a contemporary sense, Islamic finance has been present in the financial scene for the last forty years, it has made considerable progress during the last two decades. In addition, the trade-financing and real-economy oriented Islamic finance industry has proved its reliability during the recent global financial crisis period.

As part of the successful growth trajectory, the total value of Islamic financial assets in global financial markets reached \$1.814 trillion in 2014 (Reuters, 2015a). Despite such an unparalleled growth rate, the Islamic finance sector is still in a developmental stage with significant growth potential. It is projected that Islamic financial assets will reach \$3.247 trillion 2020 (Reuters, 2015a).

Islamic banking and *sukuk* issuances are two of the most popular and widely accepted *shari'ah* compliant practices in the Islamic finance industry where Islamic banks are counterparts of conventional banks and *sukuk* provides the *shari'ah* compliant nature of conventional bonds. *Sukuk*, commonly known as Islamic bonds, is an investment certificate which is complaint with Islamic law. AAOIFI(Accounting and Auditing Organisation for Islamic Financial Institutions) (2010) defines *sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or the assets of particular projects or special investment activity". In expanding, Godlewski et al. (2013) presented a detailed explanation on basic features of *sukuk*, categorisation of different *sukuk* types and historical developments in *sukuk* mar-

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kets. There are basically three groups of *sukuk*: sale-based (*murabahah*), lease-based (*ijarah*) and equity-based (*mudarabah*, *musharakah* and *wakala*).

In terms of trends in the Islamic capital markets, statistics indicate that total nominal value of outstanding *sukuk* issues in global financial markets reached $295 billion as of 2014. This implies that following Islamic banking, *sukuk* is the second largest financial asset in Islamic financial industry. It is expected that the total value of global *sukuk* outstanding will have reached $395 billion by the year of 2020 (Reuters, 2016). While the weakening in oil prices may have an adverse impact on Islamic capital markets, the indicators shows that so as to overcome the budget deficit the GCC countries may opt for *sukuk* in bringing their infrastructural development which is expected to provide further impetus for the expansion of the Islamic capital market.

The aim of this study, hence, is to examine the determinants of the corporate *sukuk* spreads in international primary markets. We analysed a data set of 63 international corporate *sukuk* issued for the period of 2004–2015. We preferred to examine primary market spreads rather than that of secondary markets due to the low liquidity in the secondary corporate *sukuk* markets. Our cross-sectional analysis showed that, as it was expected, *sukuk* credit rating was the most important factor explaining the *sukuk* pricing at issue date. In addition to the credit rating score, the maturity of *sukuk* issue as well as the size of *sukuk* issue are significant factors narrowing issue spreads, whereas *sukuk* margin rate increases issue spreads. More prominently, *shari'ah* scholar's reputation and type of *sukuk* are not statistically significant factors in explaining the issue spread. Our results are similar to determinants of conventional bond pricing and these results also confirm *sukuk* market practices. Conversely, our findings regarding the reputation of *shari'ah* scholars contradicts those of Godlewski et al. (2016).

This paper continues as follow; Section 2 delivers a survey of the empirical studies in the field; while Section 3 explains our sample, data set and empirical methodology of analysis. Section 4 affords the results of our Analysis and discussions. Section 5 concludes this study.

2. Literature survey

Although *sukuk* markets are very vital for the development of the Islamic finance industry, the number of empirical studies analysing corporate *sukuk* issuances and pricing are comparatively limited. On the other hand, because corporate bond pricing is important for market players, related literature for conventional corporate bond pricing is very rich. Intuitively, the credit rating score of a corporate bond should be the most important factor affecting bond pricing. Nonetheless, some empirical studies, such as Elton et al. (2001, 2004), Collin-Dufresne et al. (2001), Huang and Huang (2012), Chen et al. (2007) revealed that the credit risk is not the only factor explaining corporate bond pricing in secondary markets. It should be noted that in empirical studies, bond pricing is usually measured by the spread between corporate bond yield to maturity and treasury bond yield to maturity. For instance, Elton et al. (2001, 2004) indicated that taxes, liquidity, maturity and other factors explaining risk premium for stocks are also significant for bond pricing. Rather than analysing the secondary corporate bond markets, Gabbi and Sironi (2005) discussed the importance of understanding determinants of corporate bond pricing in primary markets for all market participants emphasising that there are mainly two advantages of investigating corporate bond pricing behaviour that findings enable corporations to estimate cost of borrowing and they also indicate the role of credit rating agencies. In investigating factors affecting corporate bond pricing in primary Eurobond markets, Gabbi and Sironi (2005) found that credit ratings are the most important determinants of primary market spread. Moreover, Fridson and Garman (1998) examined the likely determinants of spreads for high-yield bonds in U.S. primary markets and conclude that credit rating is the most important factor for high-yield bond pricing and underwriter reputation can be a significant factor to narrow the spread. In line with same methodology, dos Santos and Savoia (2009) analysed possible variables which may affect corporate bond pricing in Brazil. They find that inflation, credit risk and maturity are significant factors in explaining corporate bond pricing in Brazil.

Spread between corporate *sukuk* yield to maturity and treasury bond yield to maturity is a direct sign of credit risk. The expectation is that the higher the credit rating of *sukuk* is, the narrower the primary spread ought to be. Beyond credit risk is measured through credit rating scores, liquidity, tax-related variables, manager reputation, and macroeconomic variables which can all affect the spread. Unlike conventional corporate bonds, *sukuk* must be approved by a *shari'ah* board in terms of its *shari'ah* compliancy related to structure and contents at the date of issue. Along with previous factors, we questioned the role of *Shari'ah* board reputation and type of *sukuk* in primary market pricing.

Most investors reflect religious motives in their decisions to invest in international corporate *sukuk* market. The *shari'ah* compliance of corporate *sukuk* issues is assured by *shari'ah* scholars and without such an assurance *sukuk* cannot be offered to the market. Investors can change their demand on the related *sukuk* issuance through examining the quality of the *shari'ah* compliance of the *sukuk* in question. For instance, if there is doubt regarding the quality of *shari'ah* committee which approves *sukuk* issue, then investors may be reluctant to invest in this *sukuk*.

In one of few empirical studies related to *sukuk*, Godlewski et al. (2013) examined the stock market reaction to *sukuk* issuance in Malaysia and find that stock market prices respond negatively to new *sukuk* issue news. Recently again Godlewski et al. (2016) have analysed stock market reaction to 131 *sukuk* issuances, from eight different countries, for the period 2006–2013, by conducting an event study methodology. Godlewski et al. (2016) found that market reacts positively to announcement of *sukuk* issue in which highly reputable *shari'ah* scholars participated. Godlewski et al. (2016) found that the type of *sukuk* may also affect pricing in the primary market; as their result showed that market players might react