

Sukuk Markets

A Proposed Approach for Development

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Abstract

The issuance of sukuk, as an instrument in Islamic finance, has been growing in recent years. Many policy makers and businesses are looking at the sukuk markets as sources of long-term financing. The paper identifies key issues impeding further development of sukuk markets globally, namely, standardization of structures and practices, investor protection concerns relating to insolvency and governance regimes, and market liquidity. The paper also offers approaches in developing domestic sukuk markets and in accessing the international market. The authors suggest that, in developing domestic sukuk markets, policy makers use a framework similar to that of the development

of conventional bond markets, that is, by establishing (1) well-functioning money markets, (2) efficient primary markets and securities-offering regimes, (3) a robust and diversified investor base, (4) a market infrastructure that facilitates trading, price transparency, and efficient clearing and settlement of transactions, (5) derivatives market and hedging tools to support risk management by issuers and investors, and (6) a credible legal and regulatory framework. In accessing the international market, the issues policy makers or potential sukuk issuers should consider include awareness of and knowledge of sukuk, legal foundation, taxation, governance, and obligors' credit rating.

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SUKUK MARKETS: A PROPOSED APPROACH FOR DEVELOPMENT

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ACRONYMS AND ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Finance Institutions
GCC	Gulf Cooperation Council
IDB	Islamic Development Bank
IBRD	International Bank of Reconstruction and Development
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Markets
IILM	International Islamic Liquidity Management Corporation
MIFC	Malaysia International Islamic Financial Center
SPV	Special Purpose Vehicle
SRI	Socially Responsible Investment

Currencies are in U.S. dollars unless stated otherwise.

I. INTRODUCTION

Islamic financial institutions and activities have been growing rapidly in recent years. As of the date of this paper, the size of global Sharia/Islamic-compliant assets is estimated at \$1.8 trillion,² including banking assets, sukuk, and funds.³ Within this amount, approximately 15 percent is in the form of sukuk. The sukuk market size itself has grown rapidly by approximately 20 percent annual compounded growth rate in the last five years.

As a financing tool, sukuk enable more diversified financing for government and private-sector entities alike. For people who follow Sharia principles strictly, sukuk as an Islamic financial instrument provides one of only a few options for financing and investment. Therefore, developing sukuk is a way to mobilize financing and savings for a segment of population that would not be otherwise served by conventional finance vehicles. But for many, sukuk provide an avenue to tap a new investor base, that is, individuals or institutional investors in the Islamic financial markets both domestically and internationally.

Sukuk provide alternative long-term financing for key sectors such as infrastructure. Infrastructure assets that provide long-term stable cash flows are usually suitable to back sukuk structures.⁴ As several countries struggle to develop sources of long-term financing, sukuk appear as a relevant means to help deepen the pool of capital to finance investments and support growth. More than 20 percent of sukuk issued during the year 2012 alone was for infrastructure.⁵

Lack of standardization, narrow liquidity, and concerns regarding insolvency regimes are key impediments, among others, for further growth of the sukuk asset class. Despite the favorable trend, full potential of sukuk markets only be achieved will if these impediments are tackled, along with others related to a broader market development agenda. Significant efforts by the Islamic financial industry and policy makers are under way to develop standards and improve practices that could address such hurdles.

The main purposes of this paper are to (1) highlight existing impediments, (2) provide a comprehensive framework for the development of domestic sukuk markets, and (3) offer guidance on the agenda to tap international capital markets. International capital markets may be the only option available for issuers based in countries where a domestic sukuk market is not a realistic proposition. A main contribution of the paper is to take account of specific challenges the sukuk asset class facing each of the several building blocks for market development. Users of this paper are primarily policy makers who are considering developing this market or paving the way for local issuers to access international sukuk markets. The paper is also targeted to technical assistance providers and market participants in general.

The paper is organized as follows. Section II provides a brief definition of sukuk and the most common structures. Section III presents trends in the sukuk markets, providing an overview of

²See Malaysia International Islamic Financial Center (MIFC), <http://www.mifc.com>.

³There is a possible double counting, because assets in one category may be held in others (e.g., sukuk held by funds or banks).

⁴As a form of Islamic finance, sukuk do not represent ownership of debt, but rather ownership rights of assets underlying the certificates. Thus, underlying Islamic-compliant assets must be available to back the sukuk.

⁵MIFC (2013).

recent issuance volumes in domestic and international markets by different types of issuers. Section IV highlights key impediments for the development of sukuk markets. Section V proposes an agenda for developing domestic sukuk markets, and section VI offers an approach in accessing the international sukuk markets. Section VII concludes.

II. SUKUK: BRIEF DEFINITION

Commonly referred to as an Islamic bond, sukuk represent undivided, pro-rata ownership rights to the underlying assets and/or income they generate. Sukuk do not represent a claim of debt in a pure monetary sense. Under Sharia principles, money is not a tradable commodity. Therefore, interest-bearing debt—which is essentially attaching a “price” to money owed—is prohibited.⁶ Sukuk are a form of investment in which there must be permissible assets or transactions for which the investment is made. Depending on the structure, sukuk’s risk and return characteristics are often similar to bonds or debt securities, hence the common reference to sukuk as a form of debt securities.

Underlying sukuk are assets or transactions permissible under Sharia principles. The most common sukuk are the following:⁷

- *Sukuk al-Ijara*: based on leasing (sale and leaseback) transactions
- *Sukuk al-Murabaha*: based on sale-and-purchase contracts with predetermined cost and profit
- *Sukuk al-Mudharaba*: based on a partnership or profit-sharing agreement between capital providers (investors) and an entrepreneur
- *Sukuk al-Musyaraka*: based on a joint venture with an obligor
- *Sukuk al-Salam*: based on a forward contract, usually commodity
- *Sukuk al-Istisna*: based on a contract for a future delivery of manufactured or constructed asset(s)
- *Sukuk al-Wakala*: based on a contract with an agency that makes investment decisions on behalf of the investors.

More detailed descriptions of these structures are provided in appendix A.

Sukuk are often designed to mimic the cash flow structure of conventional bonds. In *murabaha* structure, the installment agreement may include a large, final payment similar to the principal payment in conventional bonds. In *mudharaba* and *musyaraka* structures, profit distribution can be designed in such way that the issuer will regularly receive a fixed amount of profit. Any excess will be distributed to the entrepreneur as an incentive to maximize profit of the business. Before 2007, the purchase of the capital investment at maturity in *mudharaba* and *musyaraka* structures was conducted at a predetermined price that is equal to the capital contribution (plus any undistributed profit). This has changed after Justice Taqi Usmani, a respected Islamic scholar and chairman of the Sharia committee of the Accounting and Auditing Organization for Islamic Financial Institutions

⁶Sharia considers money as a tool to measure value, and not an asset in itself. Thus, receiving income from money (or “interest”) is forbidden. Under Sharia, one should not sell or trade debts, and conventional lending is not permissible. The implication is that investment products—sukuk in this case—should be made for, and based on, underlying assets.

⁷AAOIFI recognizes 14 types of sukuk.

(AAOIFI), in 2007 released an opinion that the practice was not Sharia compliant because it defeated the purpose of profit-sharing spirit of Islamic finance. This issue will be discussed later in this paper.

In practically all structures, an obligor stands behind the promise of the periodic and final payments.⁸ This enables sukuk to get a credit rating in a manner similar to conventional bonds and facilitates investments in sukuk by many conventional investors. (See appendix B for distinguishing characteristics of sukuk as compared with conventional bonds.) However, a distinction is made between asset-based and asset-backed structures based on the status of the underlying assets. In an *asset-based* structure, the payments of sukuk are based on the payments of or against the assets; however, the investors do not have recourse against the assets in the event of default or insolvency. In the *asset-backed* structure, there is a legal transfer of assets into special purpose vehicles (SPVs), and thus in the event of default/insolvency, investors have a recourse against the assets.

III. TRENDS IN THE SUKUK MARKETS

The outstanding global sukuk market is estimated to be around \$310 billion, with a growth trend and record \$147 billion in issuances in 2012.⁹ In historical perspective, 2013 also exhibited a growth trend, although as compared to 2012, the issuance fell short by 15 percent. The slowdown in growth resulted in the period of May to September 2013, when the fixed-income market experienced investor anxiety and a global increase in credit spreads due to tapering expectations by the U.S. Federal Reserve. In September 2013, sukuk issuance bounced back and is expected to maintain a long-term growth trend.¹⁰ The expected growth is attributable to various factors. First, demand is increasing for Sharia-compliant assets in the Islamic world, which holds investable surplus that needs to be put to productive use. Additionally, investors are becoming more familiar with sukuk structures as more precedents and standardization take place. Finally, sukuk are viewed by some governments as an appealing instrument for promoting development and infrastructure financing.¹¹

Market breakdown: Over the years, more than two-thirds of the global sukuk have been issued in Malaysia, followed by issuances in the Gulf Cooperation Council (GCC) region (figures 1 and 2). Malaysian sukuk are predominantly issued in local currency on the domestic market. Additionally, the Malaysian market is a popular choice for foreign issuers, which reflects the country's efforts to promote the local sukuk market by building favorable regulatory framework.¹² In contrast with Malaysian experience, issuances from the GCC region are predominantly in the U.S. dollar-denominated international market (see figure 3). The preference can be attributable to investor interest in hard currency-denominated instruments and the peg of local currencies in the GCC

⁸In *al-ijara* structure, the original seller, the lessee, and the obligor (the final buyer of the assets) are in most cases the same entity, which performs different functions at different stages of the transaction.

⁹The authors thank Zauresh Kezheneva for her major contribution in gathering data and analysis for this section of the paper.

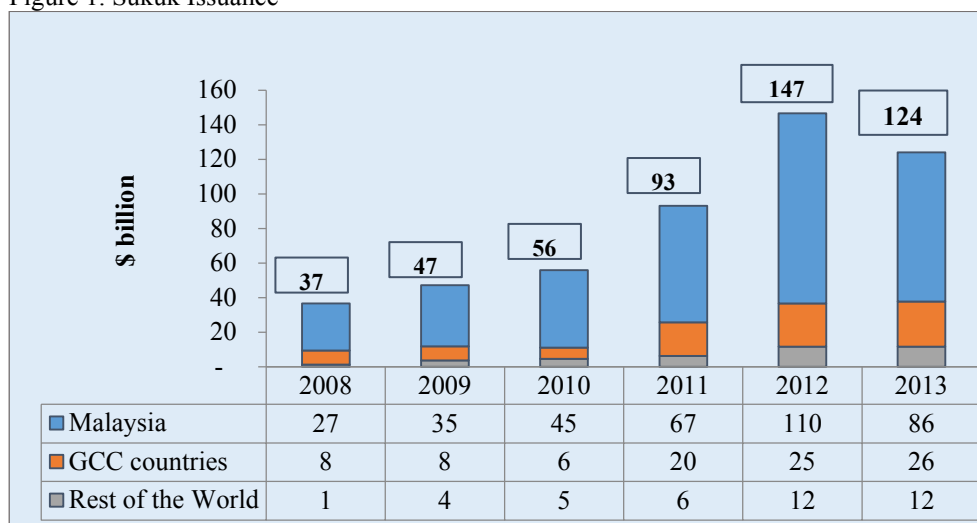
¹⁰The view of long-term growth in the coming years is shared by various market participants: from rating agencies (Moody's, Standard & Poor's) to the investor community.

¹¹For instance, the Tunisian government identified sukuk as "an important avenue to plug the Tunisian government's deficit, and raise financing for the country's infrastructure and development needs" (Thomson Reuters Zawya 2013).

¹²See Securities Commission Malaysia's Masterplans 1 and 2 (2001, 2011), which targeted establishing Malaysia as an international Islamic capital market center.

region to the dollar. However, as domestic markets in the GCC region develop, this trend may change in the medium term. Other than Malaysia and the GCC region, sukuk are expanding as a financing tool in markets such as Indonesia, Pakistan, and Turkey. Recently, a number of traditionally conventional markets, such as Hong Kong, China; Luxembourg; South Africa; and the United Kingdom have issued their first sukuk. Other markets may follow suit.

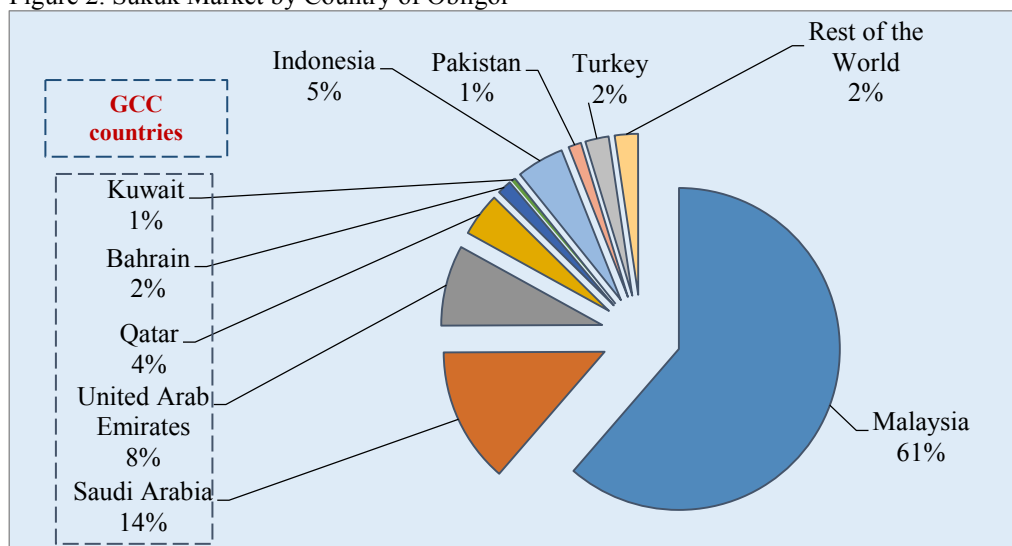
Figure 1. Sukuk Issuance



Source: Islamic Finance Information Service (<http://www.islamicfinanceservice.com>) as of April 15, 2014.

Note: GCC = Gulf Cooperation Council.

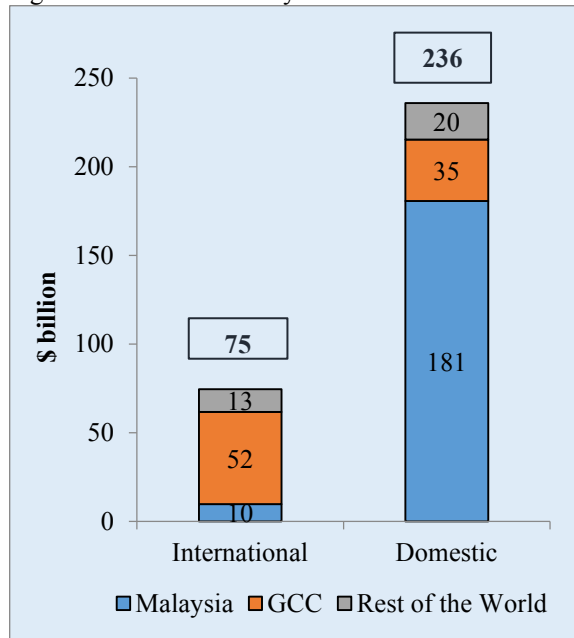
Figure 2. Sukuk Market by Country of Obligor



Source: Islamic Finance Information Service database (<http://www.islamicfinanceservice.com>) as of April 15, 2014.

Note: GCC = Gulf Cooperation Council.

Figure 3. Sukuk Market by Placement



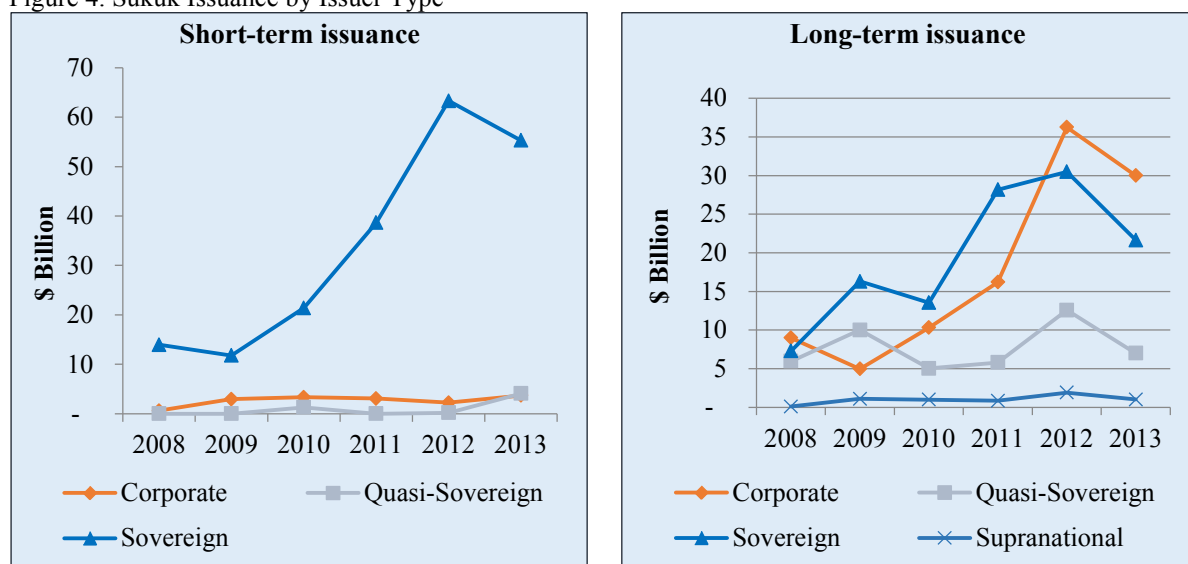
Source: Islamic Finance Information Service database (<http://www.islamicfinanceservice.com>) as of April 15, 2014.

Note: GCC = Gulf Cooperation Council.

Governments account for a larger share of sukuk issuances, but corporate sukuk represent 40 percent of the overall market and have taken the lead in the long-term segment.¹³ Governments are particularly dominant in the short-term market (figure 4). Short-term sukuk are viewed as essential for deepening and development of the Islamic interbank market and is issued in many countries by central banks to support monetary policy implementation. The Central Bank of Bahrain is a prominent example, through a regular issuance program for short-term sukuk in Bahraini dinars. In the long-term sukuk market, corporate issuances picked up and have taken the lead since 2012. In GCC countries, particularly, corporate issuers are far more active than sovereigns, partly because of the strong fiscal position of some countries in the region, and thus governments do not necessarily need funding from the capital markets.

¹³ Although a closer look suggests that many corporate issuers are state-controlled entities and therefore could be categorized as quasi-sovereign.

Figure 4. Sukuk Issuance by Issuer Type



Source: Islamic Finance Information Service (<http://www.islamicfinanceservice.com>) as of April 15, 2014.

Note: GCC = Gulf Cooperation Council.

IV. KEY IMPEDIMENTS IN THE DEVELOPMENT OF SUKUK

Despite the growth, the development of sukuk markets has been impeded by several factors. The lack of standardization of sukuk structures and practices, issues surrounding insolvency and investor protection, and lack of liquidity are key issues impeding the growth of sukuk markets and are sources of major debates among stakeholders, policy makers, and market players alike.

Standardization

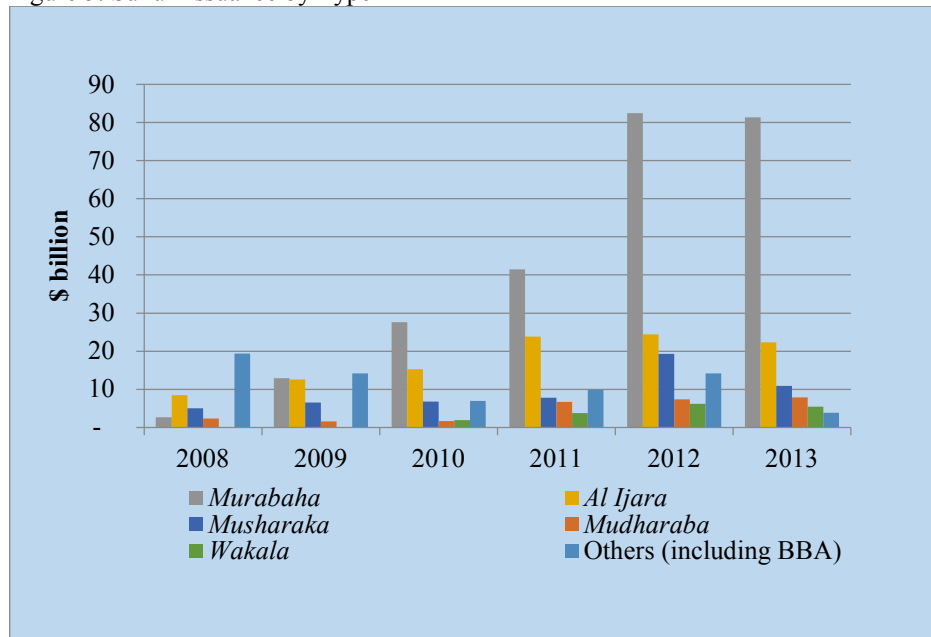
As an instrument arising from a religious background, sukuk face a challenge coming from different interpretations of Sharia principles. In one market, Sharia compliance may be based on the forms of the transactions (i.e., whether the sukuk are based on identifiable assets or transactions), whereas in others compliance is mainly determined by the intent (i.e., whether the structure adheres to the spirit of risk sharing). In the latter, structures that attempt to achieve the same economic outcome as conventional bonds are therefore considered to distort the principles.

Justice Usmani's 2007 statement drew attention to the different approaches existing in the market relating to the interpretation of Sharia principles.¹⁴ Until 2007, many sukuk had been issued with relatively loose interpretation of Sharia principles, in an attempt to resemble conventional bonds. A main criticism by Justice Usmani is that many sukuk structures imply a return guaranteed by an obligor (e.g., future purchase of investment at a predetermined price linked to its par value), which defeats the purpose of the profit- or risk-sharing spirit of Islamic finance. In reaction to this statement, the volume of sukuk issuances based on *mudharaba* or *musyaraka* structures dropped significantly in the GCC region. A similar criticism extends to a structure based on sale and

¹⁴Justice Usmani's statement was followed by AAOIFI's statement on what constitute Sharia-compliant sukuk.

immediate purchase with a promise of installment payments (called *bai bithaman ajil*).¹⁵ Debate is also ongoing about *murabaha* structure with underlying assets that are not related to the primary use of capital, although the last few years saw an increase in its use (figure 5).

Figure 5. Sukuk Issuance by Type



Source: Islamic Finance Information Service (<http://www.islamicfinanceservice.com>)

Note: BBA = *bai bithaman ajil*.

The market has been calling for standardization of acceptable structures and practices. Despite a universal concept of Sharia and AAOIFI guidelines, specific details of transactions and their structures depend on the actual interpretation and decision of the applicable Sharia boards. The industry, in its attempts to find ways for transaction structures to comply with Sharia principles while being acceptable to investors, has produced several innovative transactions. Although innovation is generally good, transaction structures are seldom comparable. This manifests in higher transaction costs (for structuring, investor analysis, etc.), which is not supportive of industry growth.

Recently, a significant, continuous effort has been made to standardize sukuk. Standard-setting bodies and joint initiatives have been established to address standardization issues impeding the growth of the market. These include AAOIFI, International Islamic Financial Markets (IIFM), the International Islamic Liquidity Management Corporation (IILM), and the Islamic Financial Services Board (IFSB). Despite these efforts, universal and international agreement on many Sharia issues has not been achieved, although evidence is seen of convergence in some of the issues. In some

¹⁵ Although the proceeds from sukuk are used to purchase the assets, the structure includes a sale and an immediate purchase of assets between the issuer/obligor and investors (via SPVs); thus, taken liberally, the assets themselves are not relevant so long as the obligor pays the sukuk holders in installments as promised. This, in essence, represents a guaranteed return by the obligor.

countries, the degree to which standards should be established at a national level (e.g., by establishing a central Sharia board) has not been fully resolved.¹⁶

Investor Protection: Insolvency and Governance

One area of debate is whether investors have a legal entitlement to the assets in the event of default or insolvency of the obligor. In practice, in many cases legal ownership of the sukuk underlying assets is not transferred from the originator to the issuing SPV because of legal and tax restrictions associated with a transfer of the asset title (either government assets or private assets). This is a common feature of asset-based structures. As a result, in the event of default, sukuk investors do not automatically take control of the assets; instead, the investors have recourse to the originator. Whether or not the sukuk investors have senior claim over the assets is still subject to debate. Such doubt over ownership of assets in a sukuk structure is also a subject of criticism by scholars who take a more “purist” position in the Islamic finance philosophy. In this school of thought, an asset-backed structure, where the assets provide a layer of protection to the investors and there is no perceived guarantee from the obligor, would represent a more truly sukuk.

Consensus over the acceptable structure (asset-based or asset-backed) would help define sukuk’s growth trajectory. At this time, both structures are applied with relative flexibility depending on the schools of thought adopted by the respective markets. From an investor protection perspective, asset-backed sukuk would probably be credit preferred¹⁷ and would remove most doubts as to compliance against Sharia principles of having true underlying assets backing the investment. However, this structure would limit the growth and use of sukuk, particularly by sovereign issuers, because of restrictions against transfer of government assets, which an asset-backed structure would require.¹⁸ The opposite is likely true for asset-based sukuk, which would facilitate more issuances but the questions of global acceptability would remain.

Another important dimension of investor protection is sukuk governance. Here, procedures for reaching Sharia-compliance status and determining the level of disclosures and investor accessibility are subject to ongoing debate. Given the complex nature of sukuk structures and the lack of consensus on Sharia compliance by scholars, thus far the approaches vary on how to set the minimum standards (e.g., qualification of Sharia boards) in the process of bringing a new issuance to the markets. In addition, policy makers still must decide, among other things, if sukuk should be available only to qualified investors, who would in principle be better capable to assess risks that these structures entail. These decisions would also affect the level of disclosure required for sukuk.

¹⁶In Malaysia, a national level Sharia board has been established. In Egypt and Morocco, a similar board is under consideration.

¹⁷In theory, a senior claim over the assets would provide additional protection to the investors. However, whether it would result in a higher credit rating would depend on the rating agency’s view. Without additional protection, sukuk holders will have equal rights to those of the obligor’s senior debt holders. Equal rights may be preferred, especially if both conventional financing and sukuk are issued for the same projects (e.g., a large infrastructure project).

¹⁸Given the link with underlying assets, one could argue that sukuk prevent an excessive leverage. An obligor would not be able to issue sukuk for more than the underlying assets it currently holds or it is in the process of obtaining through the issuance of sukuk.

Liquidity

Lack of standardization hampers liquidity. Sukuk are structured products that by nature tend to have limited liquidity. Yet, in sukuk, this issue is exacerbated by the lack of standardization of the structure. As individual sukuk are not immediately comparable, fungibility is low. Investors' decisions to replace sukuk from one issuer with another, for a credit reason or otherwise, are not straightforward like in conventional securities. Different interpretations on Sharia permissibility create market segmentation, making the market practically smaller than it already is. The lack of standardization also makes it more difficult to price the securities.

The liquidity of sukuk is further constrained by the fact that sukuk tradability also depends on their structures, following Sharia principles. Some of the structures, such as *salam*, are not eligible for trading—because if traded, they represent debt against advanced payment, which is inconsistent with Sharia principles. Other structures, such as *istisna* and *murabaha*, may not be tradable except at face value. Tradability of *mudharaba* and *musyaraka* depends on specific structure. These constraints create another layer of design challenge for sukuk and for market development generally.

A perceived short supply of sukuk drove some of the buy-and-hold behavior of sukuk investors. Currently, the market is in the state of excess demand,¹⁹ and thus investors tend to hold on to the sukuk. In turn, the lack of secondary market trades affects valuation of investors' portfolios because reliable market prices are not readily available.

V. DEVELOPING DOMESTIC SUKUK MARKETS

Several countries are seriously engaged in efforts to develop their domestic sukuk markets, with different levels of success to date (see table 1). As shown in the trends section, Malaysia stands out for its dominating market share (61 percent), but GCC countries and a growing number of countries have also initiated attempts to develop such markets. Indonesia's sukuk market, for example, has grown at a fast pace, and countries such as Turkey have developed recent regulations amplifying the set of eligible sukuk structures for domestic market placements. Bahrain, Brunei, and Sudan also have relevant volume of sukuk, being the largest issuers of short-term sukuk following Malaysia.²⁰

Table 1. Countries with Domestic Sukuk Offering

Sovereign or Quasi-Sovereign		Corporation	
Bahrain	Pakistan	France	Saudi Arabia
Bangladesh	Qatar	Hong Kong (China)	Singapore
Brunei	Saudi Arabia	Indonesia	Turkey
Gambia, The	Sudan	Malaysia	United Arab Emirates
Hong Kong (China)	Turkey	Nigeria	United States
Indonesia	United Arab Emirates		
Luxembourg	United Kingdom		
Malaysia	Yemen		

Source: Bloomberg, various sources.

Note: Although sukuk may be issued domestically and in local currencies, they may be purchased by international investors.

¹⁹According to Thomson Reuters Zawya (2013), for example.

²⁰See International Islamic Financial Market (2013).

Approaches currently adopted for sukuk domestic market development vary significantly across countries. Although some degree of variation in development approaches and policies is required due to country-specific circumstances, current distinctions are probably more associated to the nascent stage of the market and lack of standardization, among others. For example, some important tools for the development of these markets are not widely used or are still in process of being developed, such as Sharia-compliant money market and derivative products (see more details below).

Many countries wish to develop the domestic market for sukuk, but a well-functioning domestic market requires a supporting Islamic financial ecosystem. For a domestic market to work there needs to be genuine motivation for using nonconventional instruments such as sukuk. For issuers to be able to raise funding in the domestic market with sukuk, there need to be domestic Islamic financial investors who can invest in only Islamic instruments, or other investors who prefer Islamic instruments to conventional instruments. Sukuk cannot stand alone but should and will grow together with Islamic financial institutions in the domestic market, such as Islamic banking, insurance, and funds; the domestic markets provide sustainable demand for sukuk and other Islamic financial instruments. Malaysia is a good example of the relevance of a dedicated and diversified investor base.²¹

Basic preconditions for securities market must be established before the domestic sukuk market can grow. Even when the domestic Islamic financial institutions exist, sukuk markets would not grow unless the enabling environment exists to support structured instruments such as sukuk. Generally the enabling environment for sukuk is similar to that for securitization. A strong legal framework for transfer and custody of the underlying assets and a legal vehicle for sukuk issuance (e.g., SPVs or trusts) will be needed. A supportive or nonprohibitive taxation framework would allow sukuk to compete with conventional instruments. Meanwhile, supportive securities regulations, as discussed in greater detail below—including offering and approval processes that would allow sukuk to be issued in an efficient manner—and investment regulations are also important.

The policy agenda to develop domestic sukuk markets is broad and in general similar to that of developing conventional bond markets (table 2).²² A full-fledged market for government, quasi-government, and corporate issuers requires the following: (1) well-functioning money markets; (2) a reliable reference curve; (3) efficient primary markets and offering regimes; (4) a robust and diversified investor base; (5) a market infrastructure that facilitates trading, price transparency, and efficient clearing and settlement of transactions; (6) derivatives markets and hedging tools to support risk management by issuers and investors; and (7) a credible legal and regulatory framework. Given the complexity and peculiarities surrounding sukuk, the policy agenda for market development requires some adjustments.

²¹The introduction of sukuk in Malaysia (and Islamic financial instruments generally) in the early stage was driven largely by the Islamic Pilgrim Fund, one of the largest Malaysian institutional investors. Today, other than the Pilgrim Fund, Islamic investors in Malaysia include Islamic banks, Islamic insurance companies or *takaful*, and Islamic mutual funds. Conventional institutional investors also invest in sukuk because the market is sufficiently large and relatively liquid.

²²Well-established frameworks have been developed to help assess bottlenecks and build action plans to develop domestic bond markets. The most recent example is a joint paper by IMF, World Bank, EBRD, and OECD (2013).

Table 2. Building Blocks to Develop Sukuk and Conventional Fixed-Income Markets

Building Blocks	Rationale and Contribution for Market Development
Legal and regulatory framework	<ul style="list-style-type: none"> • Provides the foundations to enable issuance and boost investor confidence (e.g., laws concerning insolvency, dispute resolution) • Supports market integrity, investors' confidence, public interest, and stability of the financial system
Money markets	<ul style="list-style-type: none"> • Essential for liquidity management and to stimulate demand for longer-term instruments (e.g., collateral in repos) • Anchors prices for yield curve and derivatives markets
Reference curve	<ul style="list-style-type: none"> • Essential for valuation and broadening a range of fixed-income products and issuers • Supports public policies and investment decisions
Primary markets	<ul style="list-style-type: none"> • Facilitates market access via efficient regulatory and offering regimes • Deepens breadth of products and issuers through policies to encourage bonds/sukuk as alternative sources of financing
Investor base	<ul style="list-style-type: none"> • Supports demand and liquidity in primary and secondary markets
Market infrastructure for clearing, settlement, and secondary markets	<ul style="list-style-type: none"> • Provides safe and efficient clearing and settlement • Improves price discovery and transparency (pretrade and posttrade procedures) and stimulates liquidity (e.g., trading venues, market making)
Derivatives markets	<ul style="list-style-type: none"> • Provides risk management tools to issuers and investors • Supports price formation across cash and derivatives markets.

Legal and Regulatory Framework

The legal framework supporting sukuk market development is similar to that needed for traditional securitization. Sukuk are in fact a particular subgroup of securitizations carrying specific characteristics due to Sharia principles, but with an overall structure generally in line with other securitized products. A sound legal framework governing the creation and operation of SPVs is a key example of this common agenda. One area of particular emphasis is the legal framework for sukuk in regard to insolvency and collateral security laws. A few cases of sukuk defaults prompted greater emphasis in certifying that insolvency regimes and collateral security are adequately backed by sound and credible legislation. Being relatively new structures, these defaults served as a wake-up call to ensure investor protection and the adoption of smooth insolvency procedures.

Sharia governance is a critical item in the agenda for sukuk market development.²³ Lack of standardization of sukuk and conflicting opinions by Sharia scholars regarding Sharia compliance of certain structures pose risks to investor protection and may affect the reputation and sustainable development of the market. Establishing sound governance for Sharia approval process, compliance, disclosure, and product development is a vital pillar of the regulatory framework. In some countries governments play an active role in defining the governance framework for Sharia certification, validation, and audit.

From a regulatory point of view, the agenda for sukuk is also similar to that of other products, but complexities of sukuk structures influence a broad set of regulations. A general theme is investor protection and how it drives the level of disclosure.²⁴ Another important set of regulations in the

²³The authors thank Zamir Iqbal for his specific input regarding the relevance of Sharia governance.

²⁴See, for example, discussions in section IV on investor protection and in section V on the level of disclosure and access in primary markets.

agenda for sukuk markets, but common to other fixed-income instruments, includes regulations to (1) support creation and operation of rating agencies; (2) determine investment policies of institutional investors (e.g., pension funds, insurance companies, and mutual funds); (3) set rules for participation of foreign investors; and (4) set requirements and practices for market valuation, post-trading reporting, and secondary market architecture.

Money Markets

Money markets are the cornerstone for fixed-income markets. Well-functioning money markets allow financial institutions to manage their short-term liquidity and finance long-term positions. A liquid repo market, for example, stimulates demand for fixed-income products such as bonds and sukuk of varying maturities used as collateral in such transactions and contributes to secondary market liquidity. It also supports market-making activity, contributing to secondary market liquidity.

To support sukuk market development, money markets need to provide both conventional and Sharia-compliant products. Domestic markets in jurisdictions with strong and captive demand from Islamic financial investors typically require that short-term Sharia-compliant products be developed. These products would improve capabilities of institutions—especially Islamic banks as well as mutual funds and insurance companies—to manage their liquidity. Conventional products are equally important for at least two reasons: (1) they are usually more liquid and serve as price anchors for the short end of the yield curve and (2) they are essential for the segment of investors that invest in both conventional and Sharia-compliant products (i.e., these investors may finance sukuk positions through conventional money market transactions).

Efforts have been growing in setting standards for Sharia-compliant money market products. Sharia-compliant money market instruments suffer the same problems of lack of standardization, and there is a split in the opinion of Sharia scholars on the acceptability of repo agreements. The IFSB, for example, is working on developing Sharia-compliant securities that can be used by central banks and other lenders of last resort to provide liquidity in the market. Along the same line, the IIFM, a standard-setting organization focused on Islamic capital and money markets, has dedicated significant work and research to building money market products that can be widely accepted by Islamic financial investors (see appendix C).

Central banks have an important role to play in stimulating the development of money markets. The choice of instruments and how they are used by central banks to manage liquidity have an important impact in the development of the money market for both conventional and Islamic products. Central banks in markets such as Bahrain and Malaysia have issued a pool of short-term Islamic and conventional instruments that have supported liquidity management and the development of bond and sukuk markets.

Reference Curve

A reliable price reference curve, covering a wide spectrum of maturities, supports primary market issuance and portfolio valuation and guides policy and investment allocation decisions. The reference curve is essential for pricing sukuk in primary and secondary markets. It also helps extract market expectations for interest rates and inflation, providing the foundation for issuers and investors to decide funding and investment strategies.

Reference curves for sukuk are usually based on prices of conventional government securities. These instruments offer several features that facilitate their use as benchmarks for the whole fixed-

income market, such as in Malaysia, where both conventional and sukuk securities are issued by the government. Conventional government debt securities are simple to price and normally treated as risk-free assets in their respective jurisdictions. They are also usually issued regularly and frequently for a wide range of maturities and in large sizes that allow periodic price updates in primary markets and a conducive environment for liquidity in secondary markets.

Alternative price references may be used, depending on the context of a particular market, but shortcomings are found. Alternative price references may appear as desirable cost-effective solutions when government issuance is unnecessary (e.g., in a surplus economy²⁵ or where a government deficit is completely funded through other vehicles, such as multilateral or bilateral lending). Potential substitutes include, among other options, quasi-sovereign debt, asset-backed securities such as mortgage bonds, municipal bonds, and central bank bills. These instruments, however, suffer limitations in different degrees in comparison with government bonds due to relatively smaller amounts of frequency of issuance, higher credit risk, discontinuity of maturity across the several segments of the yield curve, and lack of liquidity. Other references such as a dollar curve (in countries using a fixed peg such as in the GCC) or swap curves are also potential substitutes, but they also face limitations.²⁶

Policies to develop reference curves are thus dependent on the choice of instruments used as price benchmarks. In the case of government instruments, building a reliable curve requires a comprehensive policy to develop the government securities market, including efficient, regular, and predictable issuance of short-, medium-, and long-term benchmark instruments, and the introduction of supporting arrangements to stimulate liquidity such as a primary dealer system and a market-making program. For reference curves based on alternative instruments, the agenda would consist of policies that could alleviate the limitations discussed above, especially with regard to the fragmentation and lack of liquidity that most alternative methods entail.

Primary Markets

A robust primary market with the presence of a broad pool of issuers requires building an enabling environment in which sukuk would be on a level playing field with other instruments. As with conventional instruments, such as corporate bonds, offering mechanisms should not be unduly onerous in terms of disclosure requirement, approval procedures, duration, and costs.²⁷ Tax treatment and investment regulations applied to different products and followed by key segments of

²⁵Several economies (including OECD countries in the early 1990s, Norway, and Singapore) have examined the pros and cons of starting or continuing to issue debt during surplus times. The overwhelming decision was to issue debt for reasons that varied from country to country, such as to stimulate the development of the capital markets or to avoid reentry costs if existing markets were to be eliminated and the government needed funding in the future.

²⁶Development of interest rate swap curves usually follows an already existing government bond curve or a robust money market reference rate from which a derivatives curve is created. A dollar curve is an attractive proposition in countries with credible fixed peg regimes because it is very liquid and covers a wide spectrum of maturities. However, dollar curves pose risk for sustainable development of these markets because they may lead to (1) excessive exposure by issuers and investors to potential shifts in the foreign exchange regime, limiting the room for maneuver by the central bank, and (2) imperfect price formation for securities denominated in the local currency, because international price references may not reflect country-specific aspects driving the cost of capital in the domestic market.

²⁷See IMF, WB, EBRD, and OECD (2013).

the investor base (e.g., pension funds and insurance companies) should also be such that do not discourage issuance of sukuk as against other sources of financing.

Common topics in the primary market agenda for conventional and sukuk instruments are the design of hybrid offering regimes and simplified public offering procedures. A hybrid offer regime²⁸ is an increasingly used issuance framework that combines the elements of a public issuance and a private offering and seeks to maximize securities' appeal for target investors, while minimizing the time and financing costs for issuers. Public offerings are also being simplified in several markets.²⁹ A tiered, differentiated approach for approval, registration, and disclosure requirements is being adopted that takes into account various factors such as the type of issuers, level of rating, and type of instruments (plain vanilla versus complex structures).

The complex nature of sukuk instruments brings additional challenges in designing and implementing primary market policies and procedures. Simplifying disclosure requirements without compromising investor protection is more challenging to do for more complex structures such as sukuk. In some jurisdictions, even hybrid regimes dedicated to targeting qualified investors are available for only relatively simple corporate bond structures. Determining the level of disclosure and regime will depend on the structure and sophistication of the investor base.

Investor Base

As in conventional fixed-income markets, a diversified investor base is essential for the development of domestic sukuk markets. A diversified investor base comprising segments of investors such as banks, mutual funds, insurance companies, pension funds, retail, and foreign investors provides the foundation for sustainable demand and deepening of any type of market.³⁰ A diversified group of investors reduces the risk of herding behavior and one-sided markets. The strategy of building a diversified investor base for sukuk involves two approaches: (1) attracting existing segments of investors to enhance allocations to sukuk as an asset class and (2) stimulating growth of specific segments such as mutual funds, pension funds, and insurance companies investing in the asset class.

The degree of complexity of sukuk products and their lack of liquidity require somewhat differentiated strategies to attract pools of investors such as retail and foreign investors. Promoting direct retail investor participation in sukuk needs to be done only under specific circumstances where policy makers are confident that the level of disclosure is adequate and that the retail investors are sufficiently qualified to understand the risks inherent to the sukuk structures. In most cases, a better solution is to promote retail investment via collective investment schemes, which in

²⁸See World Bank and IOSCO (2011) for a detailed discussion of hybrid regimes and country experiences.

²⁹The IOSCO EMC Task Force on Corporate Bond Markets recommended in its 2011 report (World Bank and IOSCO 2011) that emerging markets review their existing approval and registration processes and disclosure requirements and adopt a differentiated approach for improved efficiency of the primary bond markets.

³⁰Another relevant segment of investors are those seeking "socially responsible investments" (SRIs). This has become an increasingly relevant investment strategy, but there is scarcity of SRI fixed-income instruments. Bennett and Iqbal (2013) suggest that SRIs could help bridge the gap between Islamic and conventional finance markets.

turn require sound regulations to support growth of the asset management industry and the availability of instruments that would help these funds to operate.³¹

The apparent split between Sharia-compliant (captive) investors and conventional (crossover) investors creates relevant policy issues in the process of developing sukuk markets. Captive demand from Sharia-compliant investors may distort prices, crowd out other types of investors, and create vulnerabilities because of mispricing of risks related to credit and liquidity. Policy makers should be attentive to these possible distortions and adopt corrective measures whenever necessary. The choice of measures will vary depending on the circumstances and may usually just alleviate, but not solve, the problem in the short term. Examples of potential measures include (1) stimulating supply of sukuk by international and domestic issuers; (2) strengthening supervision and practices related to price transparency, dissemination, and valuation; and (3) improving the credit culture by fostering credit risk assessments (indirectly supporting credit rating practices) and promoting investors' awareness and literacy.

Market Infrastructure for Clearing, Settlement, and Secondary Markets

Sound market infrastructure for clearing and settlement is one of the most basic requirements for market development. Poor clearing and settlement procedures may hamper market development in several ways: They may increase risks of settlement failures, yield higher transaction costs, and limit potential market liquidity and investor diversification, for example, when market infrastructure is excessively fragmented and not sufficiently flexible to guarantee effective participation of a wide group of investors.

The focus of policies related to secondary market architecture is usually on measures to stimulate trading and promote price transparency, reporting, and dissemination. The intrinsically more liquid nature of government securities allows policy makers to introduce relatively more robust measures in this segment: (1) to promote market making (e.g., through primary dealer systems), (ii) to stimulate trading in electronic trading platforms, and (3) to promote post-trade reporting and price dissemination. For less liquid instruments, such as sukuk and nongovernment bonds, these measures are relatively more challenging to implement, but they benefit from the similar framework and infrastructure established for government bonds.³²

Secondary markets for sukuk face challenges due to lack of standardization and consensus about the legitimacy of trading certain sukuk structures. As discussed in section IV, these are currently highly debated issues that will affect the development of sukuk markets. Tackling these issues requires policies to enhance standardization of products and the design of structures that can be traded with wide acceptance as compliant with Sharia principles.

Derivatives Markets

Derivatives markets could substantially contribute to the development of fixed-income markets by (1) improving the price formation for different maturity segments (e.g., money markets and long-

³¹For example, investment funds such as money market mutual funds would require availability of liquidity management products such as repos for which sukuk held in the portfolio could be used as collateral as well as other liquidity management products, as discussed in the money market section.

³² Given their less liquid nature, sukuk may require a longer time lag for posttrade reporting.

term rates) and (2) providing risk-hedging tools for issuers and investors. Well-functioning derivatives markets complement cash markets in price formation across a broad spectrum of maturities, providing, for example, references on market expectations for changes in long-term interest and foreign exchange rates. Derivatives can also support market development by improving risk management capability for issuers and investors willing to hedge against interest rate, currency fluctuations, or even credit risk exposures.³³

Conventional derivatives meet the needs of only a portion of the sukuk investor base, and thus development of Sharia-compliant swap structures is needed. Ensuring the availability of both conventional and Sharia-compliant derivative instruments is important to support sukuk market development. Standard-setting institutions such as the IIFM have made progress in developing standards for certain types of derivatives transactions and have a pipeline of derivatives standards under development. The acceptability of certain derivative products is still under consideration as scholars forbid most conventional derivative products because of their speculative nature.³⁴ The challenges in finding broad acceptance may put Islamic investors at a disadvantage as compared with conventional investors who have more tools available to hedge and manage risks of their investments through the use of conventional derivatives.

Active policies to build derivatives instruments for sukuk market development will yield better results after progress in other areas is observed. Cash and derivatives markets are closely interconnected, but the development of cash markets usually comes first. Progress in critical areas such as money markets and the construction of a reference curve would facilitate implementation and growth of derivative products.

VI. ACCESSING INTERNATIONAL SUKUK MARKETS

To fully exploit the potential of sukuk as vehicles for development, a holistic approach is needed to facilitate access to international sukuk markets and the development of domestic sukuk markets. Agendas for conventional debt instruments tend to concentrate on domestic markets. In the case of sukuk, both international and domestic capital markets should be analyzed. While countries with pools of Islamic savings are natural candidates to develop domestic markets given the domestic Islamic financial ecosystem, many countries have found that the international markets are more accessible given the critical mass of Islamic investors. This is also true even for some countries with a significant Muslim population. For issuers from non-Muslim majority countries, the international sukuk market holds high potential to tap for funding for strategic areas such as infrastructure development.

Although many common issues are related to the development of domestic sukuk markets and in accessing international sukuk markets, their emphases are different. Some elements such as the need of a credit rating are more critical in international capital markets, whereas others such as the tax and legal framework need to be analyzed as a complement to the jurisdiction chosen to issue and distribute global sukuk.

³³ The preconditions, advantages, and challenges for developing derivatives markets in support of local currency bond market development are discussed in IMF, World Bank, EBRD, and OECD (2013). The document is part of an action plan to support local currency bond market development, endorsed by the G-20.

³⁴ The Islamic principle of *gharar* prohibits speculation and trades that are considered excessively risky.

Sukuk in the International Markets

Sukuk are developing as a global asset class, supporting development with the participation of a wide range of issuers and investors irrespective of religious orientation. On the demand side, participation of non-Islamic investors that treat both conventional instruments and sukuk as part of their investable pool of products is growing. For example, European and U.S. institutional investors, especially insurance and hedge funds, are known to be active investors in international sukuk placements. In Malaysia, the largest sukuk market to date, conventional investors actively invest in either or both sukuk and conventional securities depending on risk and return offered.

On the supply side, other than entities from countries with significant Muslim population, non-Islamic issuers are increasingly tapping the sukuk markets. These include government entities, corporations, and multilateral financial institutions (see table 3). Most of the international issuance has so far been by government or quasi-government entities because of the size and investor confidence, particularly given the issues associated with the structure and asset ownership. Although the first several issuers were entities from countries with majority Muslim population, such as those in the Middle East (e.g., Bahrain, Kuwait, Saudi Arabia) and Southeast Asia (e.g., Brunei, Indonesia, and Malaysia), issuers from non-Islamic countries or jurisdictions have also come into the picture (e.g., Germany, Hong Kong (China), Luxembourg, South Africa, and the United Kingdom), and several others are in the pipeline (e.g., the Republic of Korea).

Table 3. International Sukuk Offerings by Country of Origin

a. Sovereign, Quasi-sovereign, or Subsovereign^a

Country of Obligor ^b	Location of Issue/Offer/Listing
Bahrain	London (United Kingdom); Frankfurt, Berlin (Germany)
Saxony-Anhalt (Germany)	Luxembourg
Hong Kong (China)	Dubai; Hong Kong (China); Malaysia
Indonesia	Singapore
Kazakhstan	Malaysia
Luxembourg	Luxembourg
Malaysia	Hong Kong (China); Malaysia
Qatar	London
Saudi Arabia	Dublin (Ireland); London; Frankfurt
South Africa	Luxembourg
Turkey	Dublin
United Arab Emirates	London; United States
United Kingdom	London

b. Corporation

Country of Obligor ^b	Location of Issue/Offer/Listing
Germany	Luxembourg
Hong Kong (China)	Bermuda
Indonesia	Singapore
Malaysia	United States; London; Dublin; Hong Kong (China); Singapore; Frankfurt
Qatar	Dublin; London; Luxembourg
Saudi Arabia	Dublin; Malaysia
Singapore	Malaysia
Turkey	Dublin; London; Frankfurt
United Arab Emirates	London; Frankfurt
United States	London; Malaysia; Frankfurt; Berlin

Source: Bloomberg, various sources.

Note:

- a. Issuers in this category include national and state governments as well as state-controlled entities.
- b. Many sukuk issuances, including sovereign/quasi-sovereign, use offshore SPVs (e.g., in the Cayman Islands or New Jersey); thus it is often not immediately apparent from the database where the ultimate obligor is domiciled. Here, we attempt to identify the domiciles of the ultimate obligors.

The multilateral finance institutions have an important role to play in supporting the development of sukuk markets (see table 4). The World Bank Group, through the International Bank of Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), has helped introduce sukuk in some markets and raise their profile in international markets. Both first issued ringgit-denominated sukuk in Malaysia in 2005, and IFC continued to issue in the international capital markets. After its first sukuk issuance in 2003, the Islamic Development Bank (IDB) developed an issuance program that has seen its sukuk issued regularly and in multiple currencies (the U.S. dollar, British pound, Singapore dollar, and South African rand).

Table 4. Sukuk Issuance by Multilateral Institutions

Institution	Location of Issue/Offer/Listing
International Finance Corporation	Dubai, Malaysia, United States
World Bank (IBRD)	Malaysia
Islamic Development Bank	Frankfurt, London, Malaysia, United Arab Emirates, United States
Gulf Investment Corporation	Malaysia
International Islamic Liquidity Management Corporation	Luxembourg

Source: Bloomberg, various sources.

For many issuers, the international markets provide not only access to new types of investors, but also a supportive legal framework. Issuers will be able to select and use the legal framework in a jurisdiction that supports the creation of SPVs and issuance of sukuk. Many international sukuk were issued internationally using SPVs created in tax-friendly jurisdictions such as the Cayman Islands. Some are listed in internationally recognized markets such as London or Dublin. Many sukuk contracts are enforced in internationally recognized jurisdictions such as New York or England.

Sovereign issuers are predominant in the international markets; access to nongovernment issuers remains limited. Preference to sovereign issuers is linked not only to size and credit risk but also to concerns about default resolution that may be more complex for corporate issuers. In the event of default, difficulty may persist in obtaining local enforcement of a foreign court's decision because of the location of the assets. Thus, investors are mostly comfortable with sukuk under sovereign or quasi-sovereign names. In fact, many corporate issuers in international markets are state-owned enterprises. International investors and rating agencies consider the risks of these entities to be equivalent or near-equivalent to those of sovereign issuers.

The choice of the international market to be considered depends on the target investors and jurisdiction available to these investors. Before issuing sukuk in a market abroad, a potential issuer will need to identify the target investors and the location of issue that is most accessible to them. A sovereign issuer that wishes to tap Islamic investors from different countries may choose an internationally accessible market, such as London or Dubai. However, many Islamic investors may not have convenient access to international markets. In these circumstances, an issuer may choose to

place the sukuk in the market where these investors are located. For example, Malaysia has a large pool of domestic Islamic investors that have been tapped by foreign issuers.

Because the market has not been fully standardized, the choice of market may define the type of sukuk issued, and vice versa. *Ijara* is the most widely accepted structure, so if an issuer is to issue sukuk *al-ijara*, they would likely be sellable in most markets. For some issuers, this structure may not be suitable because it involves a pledge of assets; the issuers may not have sufficient assets to pledge, and some sovereign issuers may have restrictions associated with pledge of government's property. Meanwhile, sukuk *al-murabaha* as commonly structured are not universally acceptable, especially in the Middle East, given the perceived return guaranteed by the obligor, as discussed earlier.

Key Policy Issues in the Agenda for Accessing International Sukuk Markets

Potential issuers will need to establish an agenda in their attempt to access the international sukuk markets. Many of the items in the agenda are similar to those needed to access the international markets for conventional bonds, but there are additional steps specific to sukuk. There are also topics of common importance between international and domestic markets, most notably related to legal and tax regimes. The following is a nonexhaustive list of major items that a potential issuer will need to consider:

- *Awareness of and knowledge on sukuk.* Clearly, a potential issuer needs to establish knowledge of the potential benefits that sukuk could bring. Increased literacy would, among other benefits, help issuers identify opportunities and trade-offs between sukuk and conventional markets and make informed choices of the types of structures that are feasible. Among the questions that a potential issuer needs to consider are the following:
 - *What could the issuer get from sukuk in addition to what it can get from conventional financing? Would the benefit from issuing sukuk justify additional costs?*
Some issuers, particularly Islamic-based entities, may have a philosophical or ideological reason to issue sukuk. For these entities, the decision whether to issue sukuk is not simply a matter of cost and benefit in a pure financial sense. But for others who have conventional bond financing as their main option in accessing capital market funding, these questions are highly relevant. Sukuk require additional structuring, which would add to the cost of preparing for the issuance.
 - *What products (types of sukuk) are available? What kinds of underlying assets does the issuer have available to back the sukuk?*
Potential issuers will need to have an understanding of different types of sukuk and their respective requirements. The structure of choice depends, among other things, on the availability of assets. For example, most sovereign issuers use *al-ijara* structure because of its global acceptability, but it would require identification of tangible underlying assets and sale-and-leaseback transactions, which may not be as straightforward for government assets.
 - *Who should be the target investors?*
As noted, the decision about target investors plays a strong factor in determining where sukuk may be issued. An entity that has been issuing conventional bonds internationally may want to access available funds from Islamic-based investors in specific markets, for example, Malaysia. In contrast, an Islamic-based entity may want to issue sukuk for Islamic or non-Islamic investors alike. In the latter case, it may choose a market accessible to most global investors.

- *Legal foundation.* Despite the use of a foreign legal jurisdiction, the legal foundation in the jurisdiction of the obligor's origin must be strong enough to ensure investor protection. A strong domestic legal foundation should at least cover the following elements: (1) insolvency/bankruptcy; (2) collateralization, pledge, or transfer of assets; (3) enforceability of foreign court decisions; and (4) foreign ownership of domestic assets. Granted, the issue of insolvency or bankruptcy is relevant for any financial contract, domestic or cross-border; however, it is more prominent in sukuk because of the presumed use of collateral. The cross-border feature of international sukuk adds to the legal complexity: In the event of default, enforceability of foreign court decisions comes into question given the location of the underlying assets. When the underlying assets include property—a feature common to *al-ijara* structure—the issue of foreign ownership typically arises. A strong legal foundation for asset securitization would support the development of sukuk.
- *Taxation.* A very important element supporting the use of sukuk for financing is its level playing field and tax neutrality. Although sukuk do not represent debts or equity in a pure sense, it is important to treat them in a similar manner to conventional financing for tax purposes. A country should provide taxation guidelines specifically for sukuk, either proactively establishing new rules for sukuk³⁵ or accommodating sukuk within the existing tax framework. Although the notion of interest is not applicable to sukuk, any form of compensation to investors could be treated in a similar manner to interest of debt securities, for both the investors (e.g., tax on interest income) and the obligor (e.g., tax deductibility of the interest expenses).

A principle of tax neutrality should be applied to sukuk, just like it applies to securitization. Since sukuk requires the establishment of an issuing SPV, to which assets are transferred and through which payments are made, it is important that such an establishment does not create additional tax burden. The use of an international tax-friendly jurisdiction would solve the taxation issues related to the SPV; however, the transfer of assets and flow of payments between the obligor and the SPV may raise some taxes (e.g., value-added taxes, withholding taxes) in the country of the obligor's origin.

- *Sharia governance.* An issuance must obtain an opinion from a Sharia advisory board, which basically provides an assurance that the structure of sukuk and the manner of issuance are compliant with Sharia principles. Given the current lack of international standardization, however, an approval by a certain board does not guarantee that it would be acceptable to all Islamic-based investors. Therefore, one would need to assemble a Sharia board comprising reputable members who have similar interpretation on Sharia principles as those of the target investors.
- *Obligor's credit rating.* To be able to issue sukuk in international markets, an obligor must have a rating acceptable to the international investors, just like issuing a conventional bond. Collective wisdom suggests that most investors see sukuk as a debtlike instrument, whose degree of risk is measured through a credit rating. Credit rating agencies have established that the rating of sukuk is generally equivalent to the rating of the ultimate obligor. This principle applies to both sovereign and nonsovereign issuers. One would unlikely be able to issue sukuk if it could not issue conventional bond for a rating reason. Credit enhancement mechanisms may be considered to address this issue.

³⁵For example, in France, Malaysia, Singapore, and the United Kingdom.

VI. CONCLUSION

Growth of the sukuk market has been substantial, but significant challenges remain. The overall market faces constraints due to lack of standardization, concerns over investor protection, and narrow liquidity driven mainly by fragmentation. The Islamic financial industry is dynamic, and progress is being made rapidly, for example, through the work of standard setting boards such as AAOFI, IFSB, IIFM, IILM, multilateral organizations, and other stakeholders, public and private.

To fully exploit the potential of sukuk, a holistic approach is needed to facilitate the development of domestic markets and access to the international markets. For countries with pools of Islamic savings and the existence of a domestic Islamic financial ecosystem, the development of domestic markets is a natural choice. This paper offers an approach to assess constraints and build an agenda of reforms to develop domestic sukuk markets. The approach takes into account unique characteristics of sukuk and is based on well-established frameworks used by international development agencies and technical assistance providers to support the development of domestic bond markets. Meanwhile, for many countries the international markets are currently more accessible given the critical mass of global Islamic investors. The paper identifies key policy issues in accessing the international sukuk markets.

Policy makers engaged in sukuk development could take advantage of the ample global experience built for the development of domestic bond markets, because of the several common and mutually supportive aspects in the agenda for sukuk and conventional instruments. Multilateral institutions have an important role in disseminating international experience and supporting policy makers in the implementation of these agendas.

Large areas of future work remain. For example, although the paper identified that the development of the money markets is important for more active sukuk market, a standard solution for the design of suitable money market instruments for the sukuk market is still a work in progress. The same applies to derivative products. Similarly, the paper identified that rating is a major challenge for potential issuers in accessing the international markets, but a broad set of credit enhancement solutions is a subject of a future investigation. Still, this paper can be a launch pad for future work by multilaterals and other institutions in areas such as approaches for regulatory and governance frameworks for sukuk, roles of multilateral institutions or governments in specific sukuk transactions (e.g., credit enhancement, guarantee provider), and design of sovereign sukuk issuance strategy in the context of sovereign debt management and market development.

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APPENDIXES

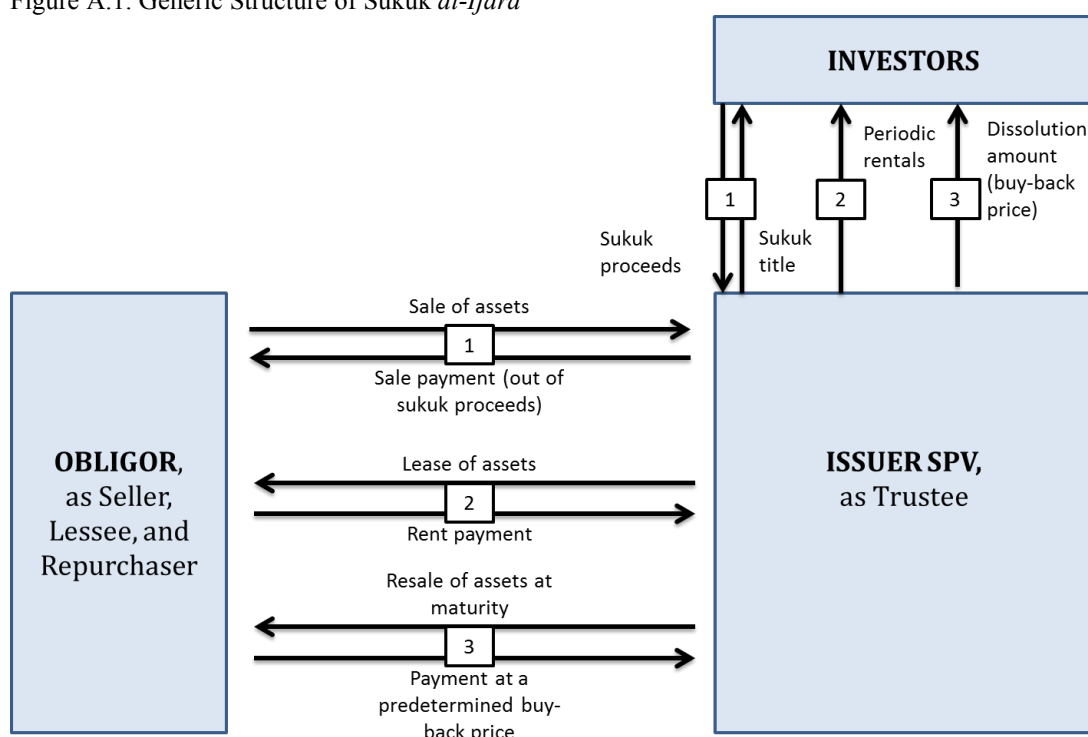
Appendix A. Description of the Most Popular Sukuk Structures

Below readers will find descriptions of the most common sukuk structures. In the figure following each description, the nodes represent flow of assets and/or cash flow at each stage of the sukuk transactions, namely: (1) fund-raising stage at the time of sukuk issuance, (2) periodic payments to investors during the life of the sukuk, and (3) at maturity or dissolution stage.³⁶

In the descriptions and diagrams below, the term “obligor” is used loosely to refer to the financed party in the sukuk transactions. This term and the term “originator” are often used interchangeably.

- *Sukuk al-Ijara*: based on *leasing transactions*. In this structure, an issuer (SPV) issues sukuk to finance a purchase of one or more assets from the obligor. The assets will then be leased out to a lessee, whose lease payments will form the periodic payments to the investors (sukuk holders). At maturity, the assets will be repurchased by an obligor at a predetermined price; the proceeds of this sale will be transferred to the sukuk holders.

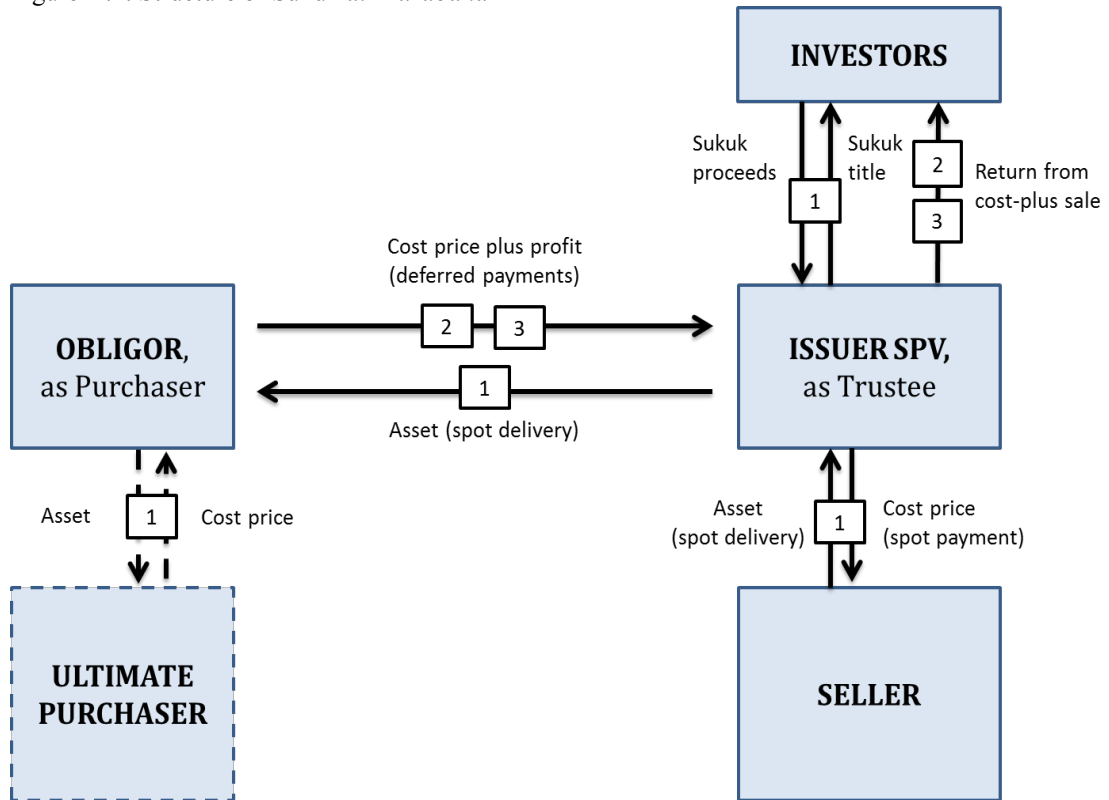
Figure A.1. Generic Structure of Sukuk *al-Ijara*



³⁶ Dubai International Financial Centre's *Sukuk Guidebook* (<http://www.islamicbanker.com>), among other sources, provides more detailed descriptions of the activities at various stages of the transactions.

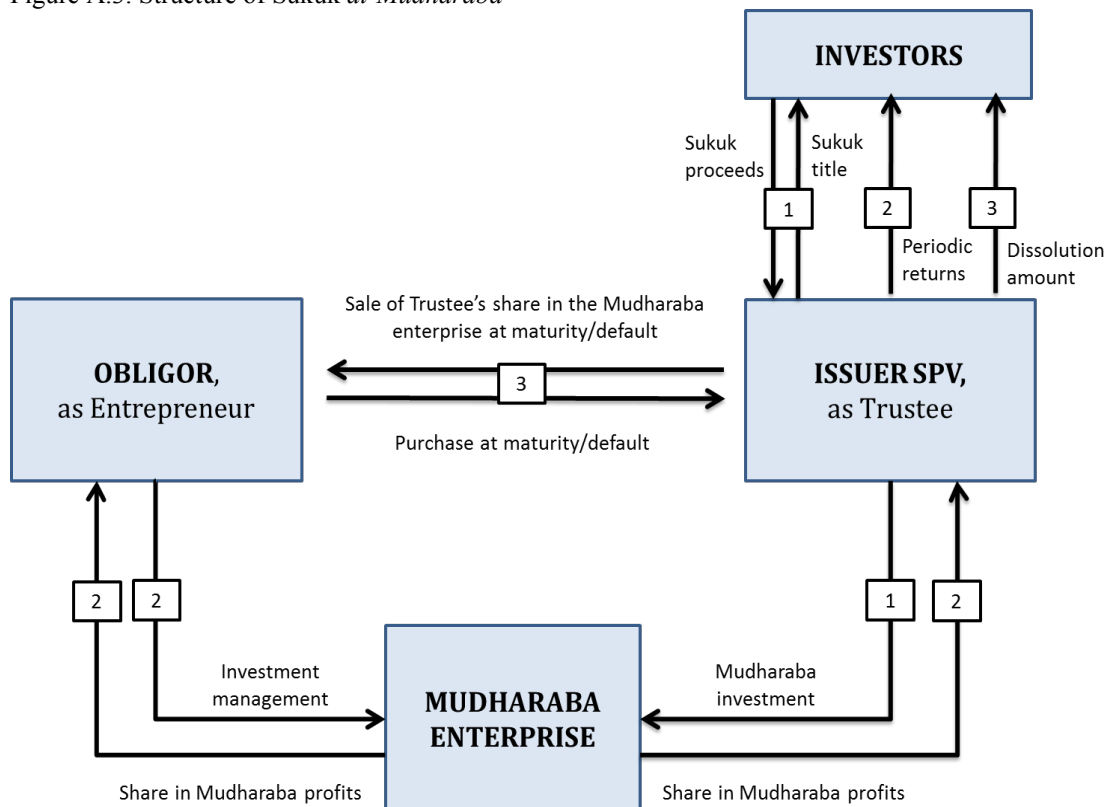
- *Sukuk al-Murabaha*: based on *sale-and-purchase contracts* with a predetermined cost and profit. In this structure, the issuer (SPV) purchases one or more assets using the proceeds from the sukuk. The assets are immediately sold at a higher price (cost plus profit) but are paid in the future, usually in installments. The installments will form the periodic payments to the sukuk holders. In many sukuk structures, the assets are on-sold to an ultimate purchaser.

Figure A.2. Structure of Sukuk *al-Murabaha*



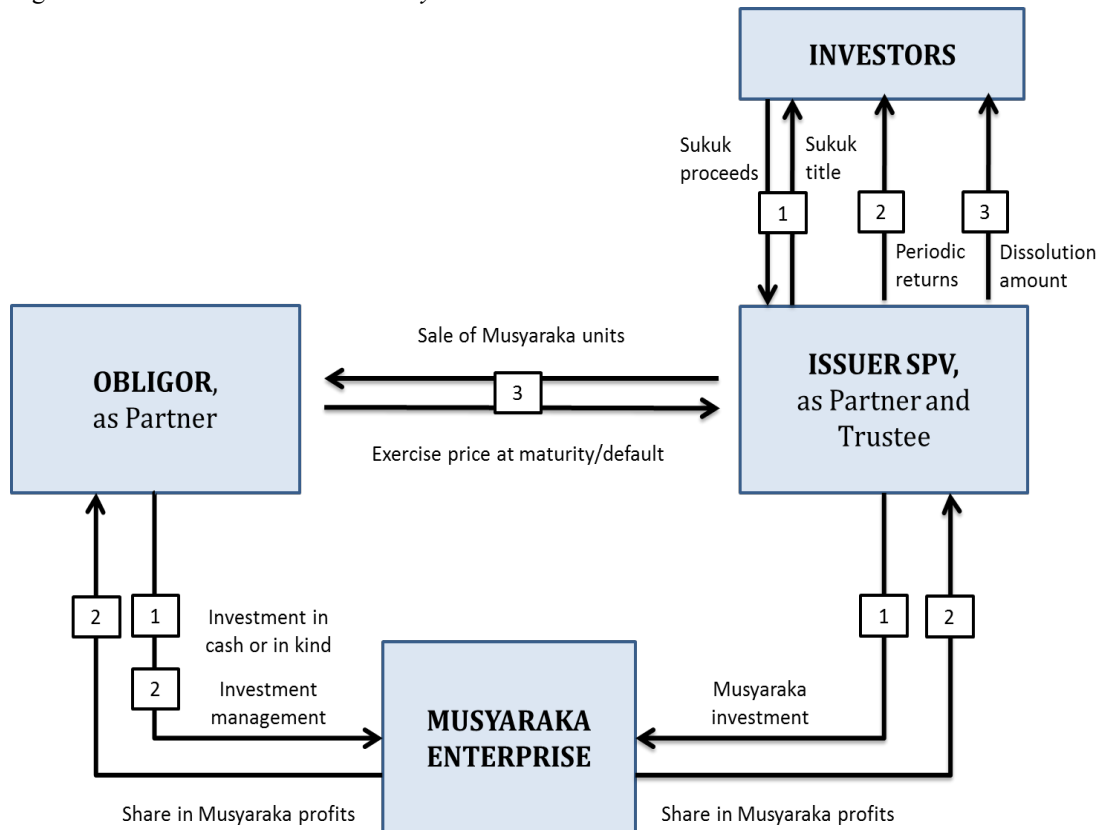
- *Sukuk al-Mudharaba*: based on a partnership or *profit-sharing agreement* between capital providers (investors) through an issuer (SPV) and an entrepreneur (obligor). In this structure, proceeds of the sukuk issuance are used by the issuer as capital to finance a business. Profit generated from the business is distributed in preagreed proportions between the entrepreneur and the issuer, the latter of which will form the periodic payments to the sukuk holders. At maturity or in the event of default, the entrepreneur will buy the issuer's participation interest in business enterprise, pursuant to the sale or purchase undertaking; the proceeds of this sale will be transferred to the sukuk holders.

Figure A.3. Structure of Sukuk *al-Mudharaba*



- *Sukuk al-Musyaraka*: based on a *joint venture* with an obligor. Similar to *al-mudharaba*, *sukuk al-musyaraka* is also used to finance a business venture, but on a joint-venture basis with the obligor. Both the obligor and the issuer contribute capital to the business, which will be managed by the obligor.³⁷ Periodic payments and payment at maturity are generated in a manner similar to those in *mudharaba* structure.

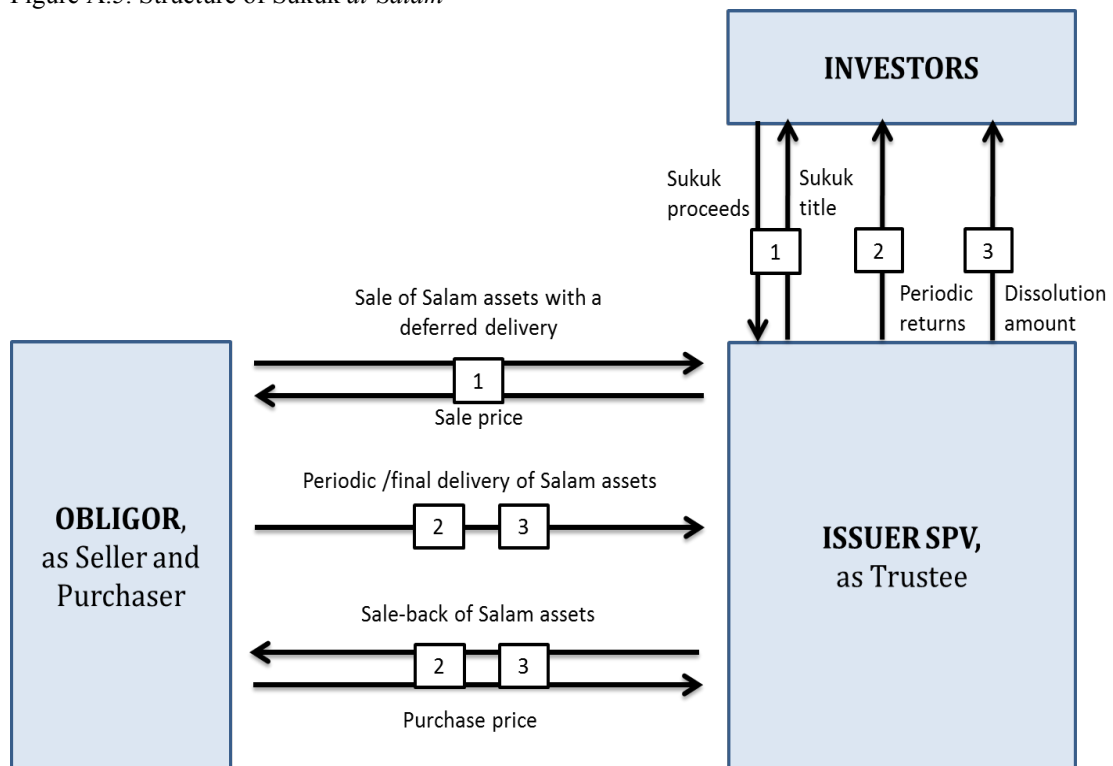
Figure A.4. Structure of Sukuk *al-Musyaraka*



³⁷The obligor may contribute in-kind capital.

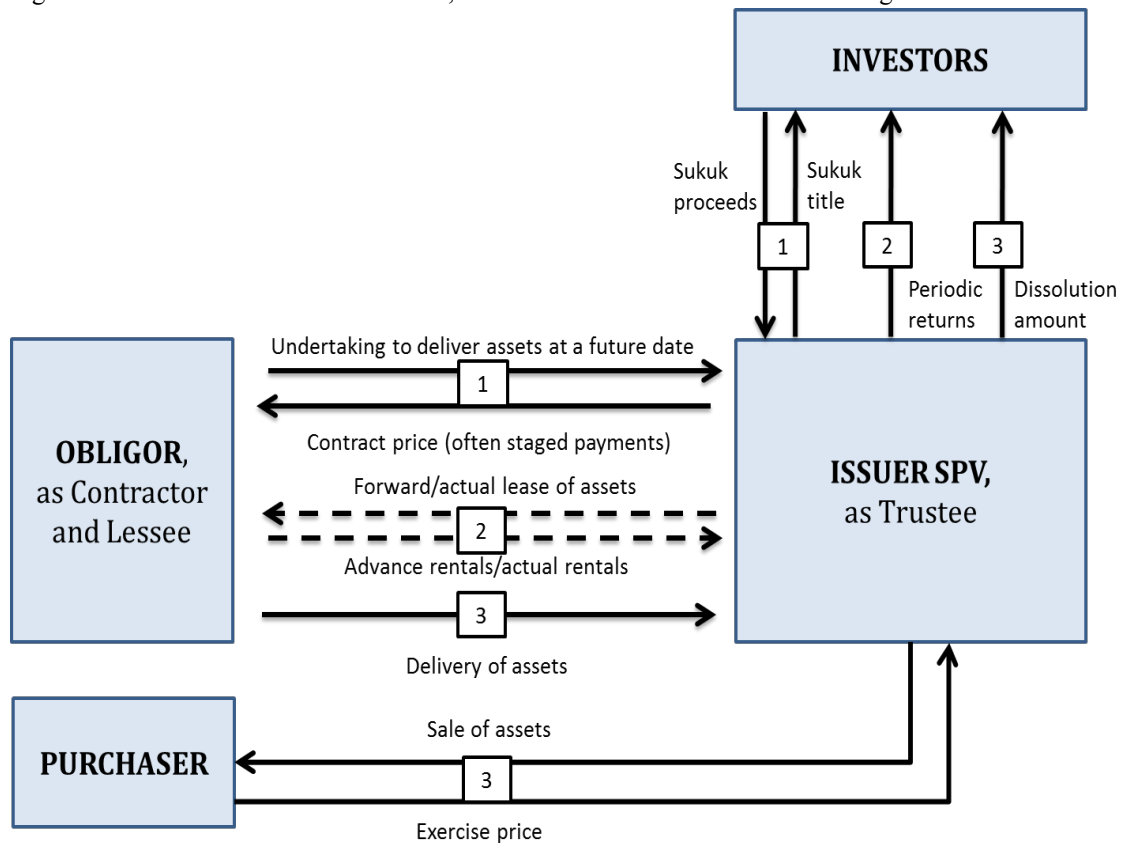
- *Sukuk al-Salam*: based on a *forward contract* (usually commodity) whereby the obligor promises to deliver an asset to the buyer (investor)—through an SPV—at a future date in exchange of a spot payment made in full. Before each date on which periodic distribution amounts are due to the investors and at maturity, the obligor will deliver the proportional amounts of *salam* asset to the SPV. Because the investors do not intend to hold the asset, it will then be sold (usually back to the obligor); the sales proceeds will be paid back to the investors. This contract is commonly used and suitable for short-term financing or liquidity management, short-term because of the price volatility of the underlying assets (commodity).

Figure A.5. Structure of Sukuk *al-Salam*



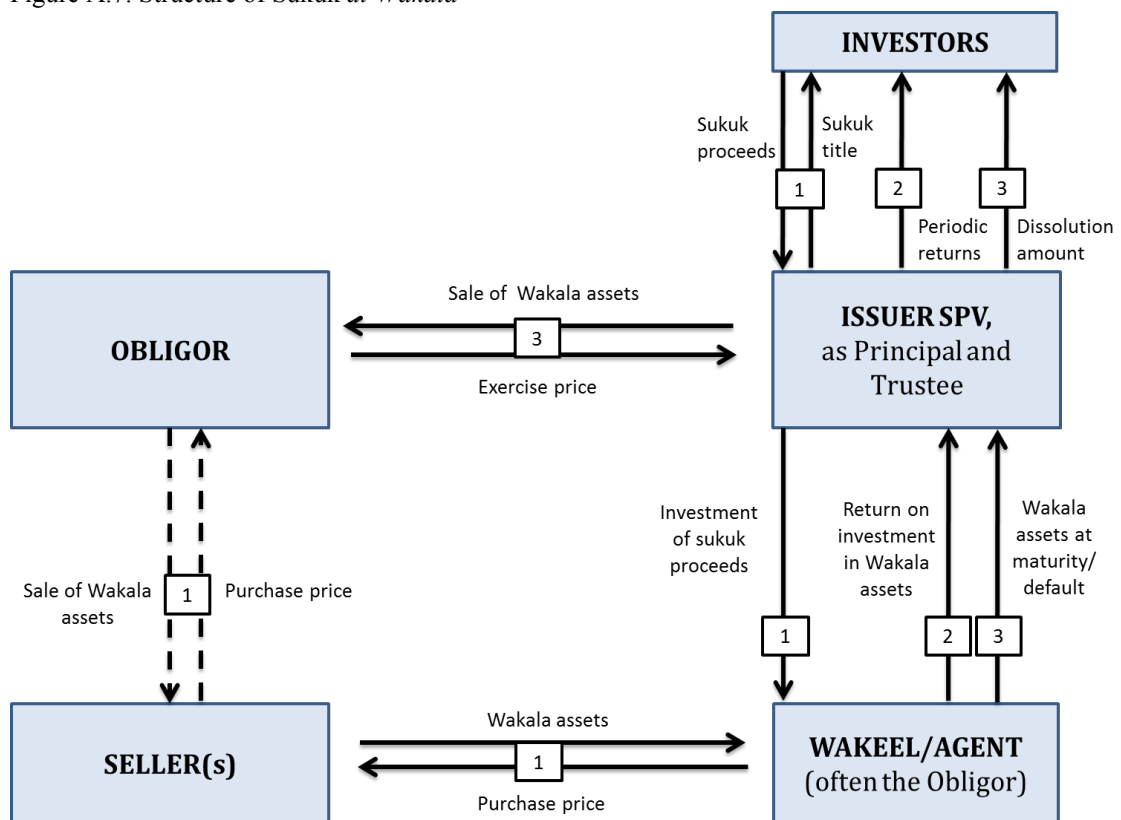
- *Sukuk al-Istisna*: slightly similar to *al-salam*, *sukuk al-istisna* are based on a contract for a *future delivery of manufactured or constructed asset(s)*. At the delivery date(s), which can be single or multiple, the obligor will deliver the asset(s). Also similar to *al-salam*, because the investors do not intend to hold the assets, they will be on-sold to an ultimate buyer, which could be the obligor. The investors will receive the proceeds of this sale. Often *sukuk al-istisna* is combined with a forward lease arrangement to enable investors to receive a return before the delivery of the asset(s).

Figure A.6. Structure of Sukuk *al-Istisna*, Combined with a Forward Lease Arrangement



- *Sukuk al-Wakala*: based on an *investment agency contract*, in which the agency invests the fund into a pool of eligible investments or assets. Commonly, the pool of investment is originally held by the obligor. The obligor in its capacity as an agent will manage the investment based on the agreement between the principal (investors, via SPV) and the agent, which among others governs the expected return (profit) and fees (usually performance based). A sale/purchase undertaking agreement governs the purchase undertaking by the obligor upon maturity and the relevant exercise price.

Figure A.7. Structure of Sukuk *al-Wakala*



Appendix B. Distinguishing Characteristics of Sukuk

Features	Conventional Bonds	Sukuk
Form of entitlement	Debt	<p>Undivided, pro-rata ownership rights to the underlying assets. However, sukuk holders do not necessarily have recourse to the assets in case of default. Investors do not own the assets, directly or indirectly.</p> <p>Common types of underlying assets:</p> <ul style="list-style-type: none"> • <i>al-Ijara</i>: leased assets based on a sale-and-leaseback agreement • <i>al-Mudharaba</i>: partnership or profit-sharing agreement between capital providers (investors) and entrepreneur • <i>al-Musyarakah</i>: partnership or joint venture with equity participation • <i>al-Murabaha</i>: sale or purchase contract with a predetermined cost-plus price • <i>al-Salam</i>: commodity forward contract • <i>al-Istisna</i>: contract for a future delivery of manufactured or constructed asset(s) • <i>al-Wakala</i>: investment contract with an agency <p>Note: No “true sale” of assets is necessary, although it may be structured that way. The term “asset based” is commonly used to differentiate it from a true-sale (asset-backed) structure.</p>
Form of return or compensation	Coupon	<p>Beneficial interest (e.g., profits) of the underlying assets/transactions</p> <p>However, many sukuk are structured in such way that they closely resemble conventional bonds in terms of risk-return profile. For example, in profit-sharing sukuk, return is predetermined at a certain level under which the obligor would cover the gap. In a case where there is excess profit, the obligor retains it. This has been a source of major debate. (See section IV.)</p>
Form of payment at maturity	Repayment of debt	Repurchase of assets by the obligor or sponsor or sale of assets to a third party, the proceeds of which will be distributed to investors (“redemption” by investors)
Issuer	Sovereign or corporate entity	An SPV (e.g., trust or company-based)
Documentation	Capital market documentation (e.g., prospectus)	<ul style="list-style-type: none"> • Capital market documentation • Sharia transaction documents depending on the structure (e.g., lease agreement in <i>al-ijara</i>)
Regulatory process	Typical capital market approval or issuance process	Typically, in addition to the same regulatory approval process as in conventional bonds, the issuer must retain a Sharia adviser (or Sharia board) whose principal role is to ensure all aspects of transaction comply with Sharia rules. The regulatory approval includes a review of the transaction’s Sharia compliance.
Primary risk	Credit risk of the issuer	<p>Usually credit risk of the ultimate obligor</p> <p>Except in case of asset-backed sukuk (where investors have the legal title of the assets, thus subject to asset/price risk), the primary risk in sukuk is the credit risk of the obligor, i.e., the entity who has the obligation to make payments, delivery, and/or repurchase of the assets in maturity or in case of default</p>
Cost	Typical	In theory should be higher due to additional regulatory and documentation requirements but typically not prohibitive
Length of time needed to issue	Typical	Possibly longer, but experience shows that it is not necessarily so except for first-time issuers

Appendix C. International Organizations for Islamic Finance

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

AAOIF³⁸ is an Islamic international autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics and Sharia standards for Islamic financial institutions and the industry. Its members include more than 200 institutions, including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry from 40 countries.

A total of 88 standards have been approved for issues on Sharia topics (48 standards), accounting (26 standards), auditing (5 standards), governance (7 standards), and codes of ethics.

Its professional qualification programs (Certified Islamic Professional Accountant, Certified Sharia Adviser and Auditor, and corporate compliance program) are part of its efforts to enhance the industry's human resources base and governance structures.

Islamic Financial Services Board (IFSB)

IFSB³⁹ is an international standards-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. It has 184 members, comprising regulatory and supervisory authorities, multilateral institutions, industry associations, exchanges, financial institutions, and professional firms operating in 45 jurisdictions.

Approved standards include Risk Management, Corporate Governance, Transparency and Market Discipline, Supervisory Review Process, Governance for Collective Investment Schemes, Special Issues in Capital Adequacy, Guiding Principles on Governance for Islamic Insurance (*Takaful*) Operations, Conduct of Business for Institutions Offering Islamic Financial Services, Guiding Principles on Sharia Governance System, Standard on Solvency Requirements for *Takaful* Undertakings, Guiding Principles on Liquidity Risk Management, Guiding Principles on Stress Testing, Standard on Risk Management for *Takaful* Undertakings, and Revised Capital Adequacy Standard.

Standards currently under development include Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (excluding *Takaful* and Islamic Collective Investment Schemes). In addition, IFSB also produces and publishes guidance notes and technical notes on specific issues (e.g., on ratings, Islamic money markets, and the like).

International Islamic Financial Markets (IIFM)

IIFM⁴⁰ is a standards-setting organization focused on the Islamic capital and money market industry. IIFM's core functionality is standardization of Islamic financial products, documentation, and related processes at the global level. Its particular strength is its ability to pool top expertise in banking, legal,

³⁸<http://www.aoifi.com>.

³⁹<http://www.ifsb.org>.

⁴⁰<http://www.iifm.net>.

accounting, and other market areas to address particular Islamic capital and money market issues. It has a Sharia advisory panel, consisting of renowned scholars, which ensures wider Sharia acceptance of IIFM standards.

Approved standards include the following:

- Master Agreement for Treasury Placement
- Interbank Unrestricted Master Investment *Wakala* Agreement
- Hedging (*Tahawwut*) Master Agreement
- Profit Rate Swap (*Mubadalatul Arbaah*)

Standards currently under development include a master collateralized *murabaha* agreement, Islamic cross-currency swap documentation, Islamic foreign exchange forward documentation, sukuk standardization and guidelines, and an Islamic credit support agreement.

International Islamic Liquidity Management Corporation (IILM)

IILM⁴¹ is an international institution established by central banks, monetary authorities, and multilateral organizations to create and issue short-term Sharia-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. By creating more liquid Sharia-compliant financial markets for institutions offering Islamic financial services, IILM aims to enhance cross-border investment flows, international linkages, and financial stability. IILM current shareholders include the central banks and monetary agencies of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Turkey, the United Arab Emirates, and the Islamic Development Bank.

⁴¹<http://www.iilm.com>.