



## ISLAMIC SUKUK: PRICING MECHANISM AND RATING

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### ABSTRACT

*The advantage of sukuk is that they are compliant with shariah principles. Sukuk are therefore attractive investment instruments for Islamic financial institutions, shariah managed funds and takaful Islamic insurance companies that cannot invest in conventional securities that involve payment of interest or riba. As well as there are an increasing number of Muslims of high net worth who want their asset holdings to comply with shariah rules. The main objective of this paper is to elucidate and describe the significance of the pricing mechanisms and rating on Islamic sukuk.*

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**Keywords:** Islamic Sukuk, Shariah, Pricing, Rating, LIBOR.

### Contribution/ Originality

This study identified the significance of the pricing and rating on Islamic sukuk which is a novel finding in the sukuk study. This study should help to fill a gap exists in the literature of sukuk characteristics. In addition, this study contributes to both academic and practitioner individuals. The findings may have some policy implications whereby the policy is made (shariah board, Islamic financial institutions management).

## 1. INTRODUCTION

One of the main challenges of sukuk that its return relies on usually benchmarked to the LIBOR on \$US dollar funds [1]. This therefore leads to an interest rate which is used only for pricing. However, such a case is dealing with riba, which is a controversial issue among shariah scholars [2].

The problem for the financial institutions is that they pursue to convey the belief of the investors to regard the sukuk as similar to conventional asset rather than being distinctive from a

financial viewpoint, as this simply risk valuation. Investors are more comfortable than if a security has a common structure better than being unknown. Thus, the innovation with sukuk is uniquely legal; their unique characteristic being shariah compliance, but there has been no financial innovation [3]. Because sukuk have familiar structures, agencies of risk rating are ready to rate sukuk in such a way there will be assurance for the investors by the global leader, Standard and Poor's, or the agency that is specializing in Middle Eastern banks' rating. Specialist rating agency in Islamic sukuk has been established through the IDB, and in Malaysia the rating agency has got wide experience of sukuk evaluation, yet the criteria that have been used are similar to other rating institutions. Thus, the main objective of this paper is to focus on pricing mechanisms and rating which are essential elements that have important impact on Islamic sukuk.

## 2. CONCEPT OF SUKUK SECURITIES

Islamic finance has sometime lost some investment opportunities for Muslims that offer an expected good return with low risk. Most of the investment opportunities are based either on real estate transactions or on stock market with high volatility [4]. Since interest-bearing bonds and fixed income are not permissible in Islamic *Shariah* and therefore *Sukuk* (Islamic bonds) are the alternative. *Sukuk* are asset-based securities while conventional bonds are debt-based securities. *Sukuk* were developed as one of the most significant mechanisms for raising finance in the markets of international capital through acceptable structures based on *Shariah* [3].

*Sukuk* is the standard Arabic term for Securities or Bonds structured according to the principles of *Shariah* and referred to as *Sukuk*, Islamic bonds, Islamic trust certificates or Islamic debt security [5].

In addition, *Sukuk* are securities that comply with the Islamic *shariah Law* and its investment principles, which prohibits the paying, charging of interest [6]. *Sukuk* are certificates of equal values representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or investment activity [6, 7]. Moreover, *Sukuk* is an asset-backed, tradable, stable income and *Shariah* compatible trust certificates. The primary conditions of issuance of *Sukuk* are the existence of assets on the balance sheet of the government, the corporate body, the monetary authority, the financial institution or any entity which wants to mobilize the financial resources. The determination of suitable assets is the first and arguably most integral step in the process of issuing certificates of *Sukuk*. *Shariah* considerations state that the group of assets should not only be comprised of debts from Islamic financial contracts such as *Istisna* or *Murabahah* [6, 8].

Furthermore, the Accounting and Auditing Organization of Islamic financial Institutions (AAOFI) defines the Investment *Sukuk* on the *Shariah* Standard No.17 as “ *certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in ownership of the asset of a particular project or special investment activity, however, this is true after receipt of the value of the Sukuk, the closing of subscription and the employment funds received for the purpose for which the Sukuk are issued* ” [7]. Also, the AAOFI listed the *Sukuk* types that are mostly used as the *Musharakah Sukuk*, *Ijarah Sukuk*, *Murabahah Sukuk*, *Istisna Sukuk*, *Mudarahah Sukuk*, and combination of some of these types if feasible [9].

In accordance with the Islamic Financial Services Board (IFSB) “*Sukuk (plural of sakk), frequently referred to as ‘Islamic bonds’, are certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture. These assets may be in a specific project or investment activity in accordance with Shariah rules and principles*” [10].

According to Malaysia Debt Securities and *Sukuk* Market sources, in 2011 *Sukuk* may be defined as certificates of equal value that represent an undivided interest (proportional to the investor’s interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services or investments in particular projects or special investment activities. Through this concept, *Sukuk* enjoy the benefit of being backed by assets, thereby affording the *Sukuk* holder or investor a level of protection which may not be available from conventional debt bonds. Moreover, unlike conventional debt securities that mirror loans or debts on which interest is paid, *Sukuk* can be structured based on innovative applications of Islamic concepts and principles. Nevertheless, *Sukuk* share some similarities with conventional debt securities, in that they are similarly structured based on assets that generate revenue. The underlying revenue from these assets represents the source of income for the payment of profit on the *Sukuk*.

The Malaysia Securities Commission defines the Islamic securities (*Sukuk*) as “*any securities issued pursuant to any Shariah principles and concepts approved by the Shariah Advisory Council (“SAC”) of the SC as set out in Appendix 1 (and subsequently) Appendix 1 (B): A document or certificate which represents the value of an asset*” (SC Malaysia, 2004 Para 1.05 a & SC Malaysia, Lexis Mexis, 2009). However, first the steps involving in the issuance of *Sukuk* prepare a detailed feasibility study. Second, they set up a general framework and an organizational structure. Third, they work out an appropriate *Shariah* structure. Fourth, they arrange lead manager. Fifth, they arrange agreed *Shariah* legal documentation. Sixth, they set up the special purpose vehicle (SPV) to represent the investors. Finally, they put *Sukuk* into circulation [6]. The model of *Sukuk* security is derived from the conventional securitization process in which a special purpose vehicle (SPV) is setup to acquire assets and to issue financial claims on the assets. These financial assets claims represent a proportionate beneficial ownership to *Sukuk* holders [8].

### 3. SUKUK AND LIQUIDITY MANAGEMENT

Before *sukuk* became available the only means for Islamic financial institutions to obtain a return on liquid reserves was to place funds through the inter-bank market on a *murabahah* basis with institutions that would buy and sell commodities on their behalf, often through the London metal exchange [3].

In the past, the funds were placing through the inter-bank market on a *murabahah* basis with firms that could sell and buy goods on their behalf, usually by the London metal exchange. After that *sukuk* became exist as the essential means in IFI in order to obtain a return on liquid reserves. This led to a mark-up payment that was seen as legitimate by scholars of *Shariah* as was depend on a real trading transaction instead of a mere return on a monetary deposit. Islamic financial institutions' problem represented by a limit number of firms able to manage funds in this way and therefore changes were kind of high with low returns.

There are more and variety options for liquidity management since the advance of sukuk, despite just the market in Malaysia could be deal with liquid, as the size of secondary trading in the Gulf to date is minimal, extremely due to the demand exceeds supply, moreover the Islamic institutions that get sukuk generally hold sukuk to maturity, and hesitate to sell [11].

#### 4. STUDIES RELATED TO SUKUK

The study work included in this evaluation is based on the early classification of time (1990-2012), which has also discussed several general issues with regard to the concept and structure of *Sukuk*. Some of these issues are highlighted:

- 1- Preliminary studies (early research) have focused on the interpretation and explanation of the basic concept of Islamic securitization and the relationship with the concept of *Sukuk*, the process and the parties involved as well as the points of view and opinions of the scholars in this regard. Furthermore, the studies focused on innovation and engineering of new ways, instruments (tools) and products. Meanwhile, some studies focused on how to introduce new product or how to make conventional product comply with the *Shariah Law*; how to make conventional bonds more in compliance with the principles of *Shariah*. There are other studies during the same period which focused on the factors that may help in the process of development of new financial products. These factors include support of government policy which gives players more rights and freedom in choosing the business products and services.
- 2- Studies in the middle focused more on the legal and *Shariah* issues. Although issues related to Islamic law have been discussed in the early period of Islamic *Sukuk* issues, more studies have become specialized after the tremendous development in the market of *Sukuk*, where many financial products have come into existence and different contracts have been used. In this stage, studies have mostly addressed issues in depth; these include issues such as the process involved in the *Sukuk* issuance, issues related to the nature of relationship between the parties involved and, applicability of such *Shariah* based contracts in some of the *Sukuk* issuance, and issues on the identity and positions of the parties involved.
- 3- Recent studies focused on standardization/ harmonization/globalization of *Sukuk*. The new trend of recent studies focused more on how to create standardized *Sukuk* by providing the views of *Shariah* on standardized issues. Some *Shariah* issues are related to *Sukuk* products, the process of the issuance, nature of the underlined assets and other controversial issues in this regard. Studies in this stage also stressed the importance of the role played by the Central Banks, *Shariah* regulatory institutions as well as the Auditing and Advisory Boards of the Islamic Financial institutions.

A number of relevant studies were found in the existing literature. For example, Palestine stock market issued a pamphlet entitled: The Islamic point of view on the contemporary securities which is concerned with lawful origin(s) of the transactions in the financial markets. This process is carried out by referring to the Islamic jurisprudent reference books as well as through looking into the contemporary jurisprudent scholars' works with regard to such transactions to see what is lawful and unlawful from an Islamic viewpoint.

## 5. FACTORS INFLUENCING ON *SUKUK*

In spite of the development of the Islamic finance industry in many respects and the growing demand both domestically and internationally on trading of *Sukuk*, there are a number of factors which are influencing on *Sukuk legitimacy* [1, 12-14].

Some researchers and scholars have pointed out the need to reconsider the method of structure and marketing of Islamic *Sukuk* that are impeded by current model to achieve the desired goals. The target audience from *Sukuk* is mostly conventional bonds audience in addition to the return of *Sukuk*, which is more like a return of conventional bonds in terms of relates to (LIBOR), or in terms of risks, or in terms of subscriptions and marketing through brokers. This led to become limited liquidity of *Sukuk* due to the limited size of *Sukuk* that offered for traded in the secondary market.

Therefore, the target audience must be the audience shares not the audience bonds, which would reduce risks as well as costs of issuance and marketing. Thus, investors will be able to take advantage of the high-return from these *Sukuk* [12]. Investment *Sukuk* are the ideal investment for investors requiring a fixed investment return with low risk and the *Shariah* Compliant [15].

In general, the study can focus on two factors which are impact to Islamic *Sukuk* in the following points:

1. Mechanisms of Pricing.
2. Rating of *Sukuk*.

## 6. FACTORS INFLUENCING ON *SUKUK*

Since the issuance of *Sukuk* is new as compared to conventional bonds, it is only natural for it to face some challenges. Pricing is a main concern for *Sukuk* since it is new to the market and has yet to develop any suitable mechanism to determine its price. According to Zaidi [14], the challenges in setting the price for *Sukuk* include:

- i) The absence of an Islamic benchmark rate due to a lack of agreement among the issuers. Hence, it has to depend on the conventional market benchmark rate (such as LIBOR or EURIBOR) to determine the pricing of the Islamic instruments.
- ii) A relatively small number of participants lead to low liquidity, lack of market depth, and a lack of critical mass of issuances.
- iii) The absence of a standard price validation mechanism to assist in distributing up-to-date news and upcoming related issues.
- iv) The lack of a focused risk based pricing mechanism related to Islamic finance.
- v) The lack of risk mitigation to manage and hedge the risk of fluctuations in the market value of instruments on account of movements in benchmark rate.
- vi) Only certain listed assets are to be accepted as guarantee.

In addition, the *Shariah* law contains restrictions on trading indebtedness in lieu of the increasing *Sukuk* issuances. Therefore, Deutsche Bank, [16] separated *Sukuk* contracts into two major categories in terms of their tradability in a secondary market with different pricing mechanism as follows:

- i) Tradable *Sukuk* at a market price: e.g. *Sukuk* Ijarah, Mudaraba and Musharak ;and

ii) Transferable *Sukuk* at face value: e.g. *Sukuk* Murabaha and Istisna.

With the importance placed on credit rating as a major factor in determining the price of traditional bonds, it becomes a major factor in *Sukuk* pricing too. Currently, the London Interbank Offered Rate (LIBOR) becomes the most common benchmark adopted in determining the price of *Sukuk* profit or rental-based return, which is undesirable under the *Sharia* law because it is an interest-based benchmark. As such, the *Sukuk* pricing process adopts the same pricing mechanism as bonds, utilizing the difference between bid and ask prices (generally called bid-ask spread), and is also determined by the trading volume.

Lane [17] maintains that fixed annual interest rate payouts to investors over the life of the conventional bond are not used for *Sukuk* bonds. Instead, *Sukuk* returns are derived from leases, profit or sales of assets such as property, equipment or joint venture business. Technically, these leases, profits or sales are structured to deliver the equivalent of a fixed annual interest rate since they are not considered as the forbidden "interest" payments. This method of distancing *Sukuk* pricing from conventional debt financing benchmarks such as LIBOR is based on *Shariah* principles is a major challenge in the Islamic capital market. Given such a challenge, it becomes more difficult to create a platform for pricing *Sukuk* on a daily basis in order to facilitate *Sukuk* trading and ascertain an active secondary market.

## 7. SUKUK RATING

In 2002, the Islamic International Rating Agency (IIRA) was jointly set up by the then Bahrain Monetary Agency (now evolved into the Central Bank of Bahrain) and the Islamic Development Bank together with other shareholders for the purpose of independently evaluating, analyzing and rating Islamic banks and instruments [18].

The IIRA is the first step in setting a benchmark for innovating, implementing and approving new Islamic investments in the budding regional *Sukuk* markets. A small hiccup here is the possible danger of IIRA restricting the authentic spirit of Islamic finance on the foundation of conservative interpretations of *Fiqh Al-Muamalat*. In practice, by adopting the Islamic financing innovation and promoting new flexible contracts, it is highly possible to avoid compromising *Shariah* financial principles and the spirit of the *Shariah*. Another risk for *Sukuk*, in the viewpoint of the conventional rating systems, is the likely exposure to the return of the original assets where the return depends on the creditworthiness of the issuer or the cash flow produced by the original assets, as well as the position of the *Sukuk* as compared to other financial responsibilities of the issuer.

Moody's <sup>(1)</sup> created a special rating method for *Sukuk*. His rating method takes into account *Sukuk*'s dependency on assets in terms of the income generated from the underlying assets. The

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<sup>(1)</sup> Moody's is an essential component of the global capital markets, providing credit ratings, research, tools and analysis that contribute to transparent and integrated financial markets. Moody's Corporation (NYSE: MCO) is the parent company of Moody's Investors Service, which provides credit ratings and research covering debt instruments and securities, and Moody's Analytics, which offers leading-edge software, advisory services and research for credit and economic analysis and financial risk management..

income can also be asset-based depending on the originator for payment through a repurchase undertaking, despite the fact that all transactions are likely to include a set of underlying asset risk which is shared by the issuer and investors. Al-Saeed [19] held a similar view with Moody by stressing on the consequence of the principal assets used to ascertain the *Sukuk* principal repayment and the applicable law.

The rating of *Sukuk* in Malaysia is corroborated by credit ratings. This is because all debt securities including *Sukuk* issues in Malaysia are required to be complemented by a credit rating at all times. Normally, an independent third party, i.e. the credit rating agency (CRA) <sup>(2)</sup> is responsible for making a credit rating in Malaysia. CRA makes an assessment on ability of the corporate issuer's to default on its debt repayments based on its history of credit repayments for all the local banks in the country. It only takes into account the debt repayment instrument instead of the overall creditworthiness or financial standing of the corporate issuer. The rating will contemplate various enhancement tools including guarantees, sinking funds, letters of credit or any other mechanism devised to reduce the default risk of specific issues. In this manner, a corporate firm may be given different rating categories for different debts at different times [20].

However, a rating is not necessarily a single reference point to purchase, sell or hold a security's market price or its suitability for a particular investment, and it may not even contain any audit by the rating agency [20].

Hafizi and Shahida [21] Claimed that Malaysia is among a small handful of countries globally which necessitate the use of CRAs to rate a bond or *Sukuk* issue. This is to help in gauging and predicting the probability of default of *Sukuk* issue, and the importance investors place on ratings for their investment decisions. Furthermore, CRAs are necessities needed by the SC in order to rate debt or *Sukuk* issues in Malaysia, as required under financial laws based on the Guidelines on Recognition of Credit Rating Agencies by the Securities Commission for the Purpose of Rating Bond Issues [22].

## 8. CONCLUSION

*Sukuk* now has become the strongest segment in Islamic finance, are involved in the international market and generate significant cross-border flow of funds as may be achieved beyond domestic markets. Along with hard work, growth and balanced development agenda, all countries have the potential to expand the role of Islamic finance is increasing in contributing to global growth and financial stability.

There are two factors that need prompt solutions in order to sustain the development of the *sukuk* structure and *sukuk* market. This requires a close cooperation among Shariah scholars and financial experts on one hand, with this, it is hoped that the Islamic *sukuk* will become more comprehensive in its *Shariah* compliance and thereby bring more credibility to the Islamic

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<sup>(2)</sup> There are two licensed CRAs in Malaysia which provide independent opinions on the credit risks and potential Default risks of specific issuers. The first rating agency, RAM Rating Services Berhad (then, Rating Agency Malaysia Berhad (RAM), was established in November 1990; and the second is Malaysian Rating Corporation Berhad (MARC) was incorporated in October 1995.

financial system in general. The focus of the sukuk market and be acceptable to international financial institutions, although these are valid and well needed objectives, but to be Shariah compliant first and foremost. This will also help in the growth of real economy.

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