

# Lack of Standardization in Sukuk Market

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## Abstract

*Although the sukuk (Arabic name for the Sharia compliant noninterest-bearing bond) market has been rapidly growing in recent years, some challenges hinder its development. Among these challenges, lack of standardization in sukuk documentation and interpretation of Sharia regarding sukuk; makes its secondary market thinner, increases the uncertainty in the sukuk market, and boosts sukuk issuance costs. Hence, both sukuk issuers and investors refrain from the the sukuk market. As a result of this situation, the sukuk market has recently reached into an impasse. Although some countries and international regulatory institutions have been putting effort to standardize the sukuk market, the problem of lack of standardization has not been completely solved. Thus, in this study, it is offered to establish a unified-international Sharia board, which would bind rules and standards to guide the sukuk market. By establishing a Sharia board, it is expected to have a more standardized and developed the sukuk market in the near future.*

**Keywords:** *Sukuk, Standardization, Islamic Finance.*

## 1. Introduction

Islamic finance industry has recently been growing rapidly. Along the same line, the sukuk market has also been developing very fast due to the high demand, tax regulations and legislations regarding sukuk, and increasing investor base. Nevertheless, since there are various challenges in the development of the sukuk market, sukuk has not reached its peak level yet. One of these challenges is the lack of standardization in documentation and interpretation of Sharia.

In sukuk industry, standardization has two sub-problems. One of these problems is lack of standardization in documentation, and the other is lack of standardization in

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Sharia interpretations related to sukuk structure. Sukuk markets have been suffering from these two types of the standardization problems. Therefore, the sukuk market has not realized its potential yet. As a result of lack of standardization; primary and secondary the sukuk markets remain thin, sukuk issuance costs and uncertainty in the sukuk market remain very high. Hence, the standardization problem is one of the main problems to be solved so as to benefit from sukuk efficiently.

Although standardization is a major obstacle to further development of the sukuk market, there is not much interest in the standardization problem in the literature, except from Papazian's (2010). Therefore, the purpose of this paper is to properly explain the lack of the standardization problem and its types, research the advantages and disadvantages of it, and propose some solutions to the problem.

The paper consists of three sections. In Section 1, we dwell on the standardization of Islamic finance. Then in Section 2, we introduce standardization in sukuk, types of standardization, standardization efforts, and advantages of standardization. Finally in Section 3, we propose some solutions in order to overcome the standardization problem.

## **2. Standardization in Islamic Finance**

Islamic finance industry has grown very fast even though it is a tiny portion of global financial markets (IMF, 2015; Ahmad et. al., n.d.). Islamic finance market size is estimated to be roughly \$2 trillion (World Bank, 2015), with expectations of market size to be \$3.4 trillion by the end of 2018 (Naveed, 2014). On the other hand, Islamic finance industry has been growing at between the rates of 10% and 12%, annually (World Bank, 2015). In fact, this trend is expected to continue in accordance with the growing demand to Islamic instruments, and strong economic growth in countries in which industry develops.

In spite of its fast growth, there is still room for further expansion for the Islamic finance market. In other words, since there are a lot of problems which impede the growth of Islamic financial market, it has not realized its full potential yet. As one of these problems, lack of standardization hinders the development of Islamic financial market (IFN Corporate, 2016a; Reuters, 2016). It is undeniable that Islamic finance industry is growing fast; however, it may even be faster, when there is an overall standardization (Oshodi, n.d).

Regarding the subject of Sharia ruling, there are quite different opinions among Sharia scholars. Sharia law is open to interpretation, and Sharia scholars often declare their



different opinions about issues of Sharia. A view, which is expressed by some of the Scholars, may be denied by other Sharia scholars. As a matter of fact, Sharia scholars can choose different schools of thought to make decisions about any financial transaction's compliancy to Sharia. Hence, the key problems for Islamic finance industry are the lack of standardization in Sharia rules, and instrument transaction structure. Without the standards, each country and institution can have their own approach to the Sharia regulations of the Islamic financial transactions. Therefore, there can be numerous different point of views in Sharia and transaction types in the Islamic world. To be precise, Islamic finance laws and regulatory practices vary according to the countries. Thus, the lack of compatible viewpoints make it difficult to standardize the Islamic financing (Illias, 2010:2).

There are a lot of negative consequences of the diversity in Sharia scholars' opinions. According to the many of the scholars, the risk of lacking compliance to Sharia may grow without standardization; since practices differentiate considerably according to different jurisdictions. That is to say, many Islamic finance practices can be valid for a jurisdiction, while they are invalid for the others. For example, while Deutsche Bank would argue that Waad or even double Waad are valid contracts in Islamic finance, Malaysia would assert that sukuk on the basis of Bai Dayn and Bai Inah are also recognized contracts in the field (Oshodi, n.d.).

Standardization efforts can make Islamic finance more prestigious in the world, however, there are only a few institutions aiming the standardization of Islamic finance industry. In this regard, Accounting and Auditing Organization for Islamic Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and International Islamic Financial Market (IIFM) have been making reasonable efforts to standardize the Islamic finance industry since 1990s. With the purpose of standardization, AAOIFI, IFSB and IIFM have been setting forth basic Sharia rules, and they have been putting an effort in this direction (State bank of Pakistan, 2015:018; Oshodi, n.d.). For example, AAOIFI has been going through a revision of all its standards since 2015, and has prepared 10 new standards in 2015 (Kalimullina, n.d.). On the other hand, AAOIFI has published a draft Sharia standards document on the use of gold in financial instruments (IFN Corporate, 2016). IIFM and International Swaps and Derivatives Association (ISDA) launched two new standards for Islamic foreign exchanges (Idraki, n.d.). Nevertheless, little progress has been achieved about standardization, since the standards are adopted by just a few jurisdictions.

Despite the standardization efforts made in the last 25 years, diversity in Sharia



rulings and instrument structure is still going on. This is because, standards launched by international Islamic institutions are not associated with each other (Alshamrani, 2014:327-331; Bukhari et. al., 2014:1700); and stakeholders in the Islamic finance industry do not support these institutions and their ruling. Hence, many jurisdictions have failed to implement these standards (Desai, 2016). It seems that, under these circumstances, Islamic finance industry will not be able to reach to a new level. In this regard, Islamic finance industry can develop only if the standardization can be achieved. Otherwise; uncertainty, lack of clarity and conflicting interpretations will not stimulate the confidence and may even slow down the pace of the development (IFN, 2010).

### **3. Standardization in Sukuk**

Sukuk, as a rising star in Islamic finance, has become the most popular instrument in Islamic finance industry. In other words, sukuk issuance has been rising since 1990s. In the recent history, the sukuk market has reached its peak levels. Especially in 2012 and 2013, sukuk issuances reached to just over \$135 billion. However, since 2014, sukuk issuance has been slowing down considerably. By 2016, the sukuk market is expected to be worth \$50 to \$55 billion (Standard & Poor's, 2016:2).

However, the sukuk market cannot realize its full potential unless the challenges of the sukuk market have been overcome. Within these challenges, we can identify the current asymmetries in the tax treatment of sukuk and conventional bonds, which disadvantage sukuk bonds (Q&A and Raja, 2015), and lack of liquidity in the secondary the sukuk market (Bennett and Iqbal, 2011:70; Al Elsheikh and Tanega, 2011:188). There is no doubt that lack of standardization in sukuk is the most important challenge, which hinders the sukuk market development (Al-Fayez, 2009:1). Thus, lack of standardization has been slowing down the development of the sukuk market, while there are still very different views about the necessity of standardization.

#### **3.1. Is Standardization a Must?**

Standardization in sukuk has become a highly controversial topic as there are two opposite views about the necessity of standardization in sukuk (McAughtry, 2015; Yussuf and Soualhi, 2011:125). For the supporters of standardization, since standardization is regarded as a solution for the sukuk market growth; liquidity in secondary market and investor confidence, and uniformity of rules in sukuk are necessary. On the other hand, standardization does not constitute an impediment to further innovation in the sukuk market products. Standardization leaves space for the innovation (IFN Corporate,



2016a). In this regard, standardization could provide room for free capacity for stakeholders to focus on innovation in order to develop new Islamic financing products that cater to the opportunities created by the regulatory changes in the global financial system (John, 2016; Damak, 2016a; Saudi Gazette, 2015; Standard & Poor's, 2014b:5). Thus, standardization in sukuk is a must to overcome the sukuk market challenges.

However, according to adversaries of standardization, lack of standardization does not necessarily result in a negative way; it rather gives more flexibility to the Islamic bonds and instruments (Ahmad et. al., n.d.; Kasri and Tijani, n.d.). When there are differences in standards, considerable innovation and diversity will be able to be achieved in sukuk types. Therefore, standardization efforts could also hinder product development in sukuk industry (Kronfol, 2015:5). According to adversaries of the standardization, in fact, the diversity in sukuk structures in Islamic finance is an outcome of the differences in sukuk standards (Ahmed, n.d.). So for the opposition of standardization, standardization is not a must for further development of the the sukuk market.

According to the moderate viewpoint, it is no doubt that standardization has a lot of beneficial consequences. However, there must be a balance between standardization and innovation (Jobst, 2011:70). In this regard, standardization must be realized, but it should not hinder the innovation. As the standardization is a must for the the sukuk market development, we share the third view. In our opinion, lack of standardization is the cause of a lot of the sukuk market challenges such as illiquidity in secondary market, lack of investor confidence, and low flow of funds across the borders (McAughtry, n.d.; IFR, 2009; Hanefah et. al., 2013:118; Yussof and Soualhi, 2011:125). Hence, standardization can overcome these challenges and help developing the sukuk market (ADB, 2014:43). In this regard, standardization is a key for the future growth of the sukuk market (IIF, 2014:10) Therefore, there is a big necessity for the sukuk standardization, and for sukuk industry stakeholders. (ADB, 2014:43; Kusuma and Silva, 2014:57; Muhammad and Alvi, 2010). On the other hand, standardization should not hinder innovation too. Thus, we need a balance between standardization and innovation. In other words, the sukuk market can benefit from standardization if it attracts new issuers and free stakeholders' capacity to focus on innovation (Damak, 2016b).

### **3.2. Types of Standardization**

Standardization types include documents'-structures' and Sharia rulings' standardization. (Nazar, 2011:11; Saudi Gazette, 2015; Damak, 2016a). Although some institutions such as AAOIFI prepared standards including sukuk, a standardized sukuk



documentation or structure has not been published yet. Additionally, the sukuk market has been negatively affected by lack of standardization in Sharia ruling throughout the time. As the sukuk market, as a part of Islamic finance, has four different schools of thought, Sharia scholars express different opinions about Sharia compliance of sukuk structures.

### **3.2.1. Standardization in Documentation and Structures**

Since there are a lot of types of sukuk structures, standardization in sukuk documentation and structures has not been achieved yet. Hence, there can be difference between rights of issuers and investors in terms of the sukuk structure. In addition, there is no uniformity about investor rights in practice. Although it is obvious that lack of standardization hinders the sukuk market growth, there has not been much effort to standardize the sukuk documentation in the recent years (Haider and Azhar, 2010:43). And efforts to standardize sukuk documentation were ill-fated attempts (Ali, n.d.:9).

Although AAOIFI and IIFM have made efforts to standardize sukuk documentation, there is still discrepancy among jurisdictions in sukuk documentation. For example; as the issuers have recently issued asset based sukuk excessively, and according to AAOIFI sukuk holders should have rights over sukuk assets; assets should be sold legally and there must be the transfer of the assets (Yean, 2009:3). In this case, asset based sukuk holders have no right of recourse on the underlying assets under the terms of contracts (Siddiqui,2016:162). This shows that the sukuk documentation in the sukuk market is not properly standardized yet.

On the other hand, according to the Islamic principles, sukuk must rely on Sharia rules. But in practice, documents are governed by the law of particular governments rather than Islamic law (Alawi and Al-Quati, 2014:2), which may give rise to different sukuk documentation structures according to the laws of particular states. Hence, there can be conflicts between Sharia compliant, standard-unified documentation and laws-legislations of sovereign countries (Reuters, 2016).

Due to different the sukuk structures, conflict between laws of different states and Sharia principles, and different document types in practice have caused the situation of having no standardized documentation. Thus, lack of standardization has affected the sukuk market growth negatively, because of vagueness in documentation and rights of the parties.

On the other hand, a variance continues to exist in Sharia products at an international



level, whereby a Sharia compliant product for one authority, may not necessarily be accepted as being Sharia compliant for another (Deloitte, 2016:19). For example, while AAOIFI specified 14 types of sukuk such as murabahah, istisna, salam, ijarah, mudarabah, muaharakah, wakalah, muzarah, musaqa, muqarasah, ijarah mowsufa bithimn, manfaah ijarah (Safari et. al., 2014:101), Malaysia issued bai' al-inah and bai'al-dayn sukuk structures. However, bai' al-inah and bai'al-dayn have been criticized by most of Islam scholars (Rosly and Sanusi, 1999). Thus, it can be said that there is not standardized sukuk structure in the sukuk market yet.

### **3.2.2. Standardization in Sharia Principles**

While there are four different schools of thought in Islam, the Islamic issues are open to interpretation (Ahmad et. al., n.d.). There are a lot of Sharia scholars who agree and confirm the thoughts of various ideologies. Thus, the ideas of Sharia scholars from different states or organizations may differ regarding a lot of Sharia issues.

In Islamic finance, the most important necessity is the compliance to Sharia rules. For the purpose of Sharia compliancy of an Islamic product, Sharia scholars interpret the specific Islamic rules regarding this product and decide whether the product is Sharia compliant or not. However, the problem is that there is lack of uniformity among scholars in terms of interpretation of Sharia rules (ADB, 2014:43; Amundi, 2013:3; Anuar, n.d.). Even, it might be seen that two regulatory organizations (AAOIFI and Kuala Lumpur based IFSB) may make divergent interpretations in determining what is acceptable under the terms of Sharia law (Oxford Business Group, 2010:97).

In sukuk, standardization has not been achieved yet, since lack of uniformity in terms of Sharia interpretation among scholars is also effective for sukuk too. Therefore, as many scholars state that there is not a global uniform standard about Sharia interpretation of sukuk yet (Jobst et. al., 2008:10; Azhar, 2013:225; Brugnani, 2008:24; Hamdan, 2010). Each country and even institution have their own Sharia boards and so their own resolutions (Kasri and Tijani, n.d.). Some countries (such as Malaysia) adopt flexible approach for interpreting the Sharia, while others (such as GCC) adopt conservative approach (Al-Fayez, 2009:2; Kronfol, 2015:5). Hence, fatwas (opinions) about sukuk can mostly be different.

Before the issuance of the sukuk, the opinion of the Sharia board on whether it is acceptable or not should be taken. In most of the global sukuk issuances, when sukuk structure is ratified by Sharia board(s), the status does not change, despite the situation of having conflicting views from other scholars later on (Amundi, 2012). However,



sukuk structure, which is endorsed by only one Sharia board, can be prohibited or rejected by other authorities or by different Sharia boards of various countries (Kusuma and Silva, 2014:20; Salah, 2011). For example, bai bithaman ajil were considered as tradable in Malaysia, but Gulf scholars considered them as unacceptable (Kronfol, 2015). This problem causes additional costs and time for the market (IFN Corporate, 2016b; Rohmatunissa, 2008:2), and as the result, this problem is an impediment to further development of the sukuk market (Al-Fayez, 2009:7; Gelbard et. al., 2014:6; Kasri and Tijani, n.d.). For that reason, the developments in the sukuk market have been calling for standardization in terms of Sharia rulings (Kusuma and Silva, 2014:7). Hence, there is an urgent need for new Sharia standards in order to keep pace with developments in the sukuk sector (Reuters, 2016).

### **3.3. Standardization Efforts**

Standardization efforts have been made by many countries and international regulatory institutions such as AAOIFI. Recently, many countries have established national Sharia boards, and international regulatory institutions have established regulations about sukuk. But, regulations of the countries related to Sharia issues are not in accordance with other states or organizations (Kronfol, 2015). Hence, although some standardization in sukuk has been achieved, the main problem is the absence of a global standardization (Kamal, 2008:30).

#### **3.3.1. Standardization Efforts Made by Countries**

A lot of countries have been making efforts to standardize the sukuk market. In this regard, the governments aim to increase the sukuk level to %50 of the total debt issuance over the next decade (IFN Corporate, 2016a).

A lot of countries have been establishing national Sharia boards to standardize their sukuk markets. In this regard, efforts of Malaysia are laudable. Malaysia has established the Shariah Advisory Council (SAC) to govern Islamic financial businesses and products. SAC comprises prominent Sharia scholars, jurists and market players (Ahmad et. al., n.d.). They advise central bank and the Securities Commission (SC) on issues related to sukuk and other Islamic capital market products (Aljazira Capital, 2010). On the other hand, the SC has established a memorandum of understanding with Universiti Sains Islam Malaysia (USIM) to support the publication of global Sharia standards. IFSB has also been making effort to surmount the difficulties about standardization (Ahmad et. al., n.d.). In addition to these efforts, Malaysia has established the International Islamic Financial Centre (MIFC) to constitute guidelines about sukuk (Aljazira Capital, 2010).



Other countries have also been making efforts to standardize sukuk transactions. For example, Pakistan has established a Sharia Board within the State bank of Pakistan. United Arab Emirates, Bahrain, Indonesia, Oman, Nigeria and Morocco have also established similar bodies (Ibrahim, 2011:669). On the other hand, the Dubai Financial Market preferred to announce specific guidelines for sukuk issuance (Kronfol, 2015:4).

Countries which are in Islamic financial market have been making efforts through adopting some international standards prepared by international regulatory institutions such as AAOIFI (Ahmed, 2007a; Ahmed, 2007b). The Sharia authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia and South Africa have issued guidelines related to sukuk based on AAOIFI's standards (Amundi, 2012:3); so it can be said that if the number of the countries which adopt international standards increase, the standardization might be achieved in the near future.

### **3.3.2. Standardization Efforts Made by International Institutions**

Standardization efforts which have been made by the international institutions may no doubt be regarded as a positive development. However, the problem is that their rulings are not binding (Kronfol, 2015:5; Bukhari et. al., 2014:1700). Hence, interpretations on standards made by countries and sukuk issuers differentiate significantly (Azhar, 2013:220). On the other hand, although many countries and issuers adopt standards issued by international institutions (Harrison, 2010:11), all countries and issuers have not been following these standards (Hamdan, 2010).

There are only a few international institutions which are established in order to issue international standards related to Islamic finance and sukuk. These are such as following: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), International Islamic Financial Markets (IIFM), Dubai International Financial Center (DIFC), and The Islamic Development Bank (IDB).

AAOIFI, which was founded with the intention of becoming a global authority, has been established in Bahrain in March 1991 with the purpose of issuing accounting, auditing and governmental standards for of Islamic financial institutions' (IFIs) functioning successfully (Nanaeva, 2010:33; Kronfol, 2015:5; Al-Sayed, 2013:71; Gelbard et. al., 2014:4). Related to sukuk, AAOIFI issued Sharia standard number 17, which became effective on January 1, 2004; in May 2003. This standard defines sukuk investment and describes 14 different sukuk structures. Standard number 17 also includes specific rules to preserve the Sharia compliance of each sukuk structure



(Safari et. al., 2014:43-44). In 2008, AAOIFI has issued 6 specific standards that are also related to sukuk. These standards criticized the sukuk practices and affected the the sukuk market negatively.

IFSB was established in Kuala Lumpur, Malaysia in November 2002. Its objective is to develop international prudential and supervisory standards for IFIs (Nanaeva, 2010:33; Al-Sayed, 2013:71; Gelbard et. al., 2014:4). On the other hand, one of its main purposes is standardization of Shariah rulings (Kaseb, 2010:10).

IDB, which was established in 1975, functions in order to make sukuk issuance simpler in terms of Sharia rulings (Albawaba Business, 2016). In this regard, IDB has been trying to achieve more standardization in sukuk (Damak, 2016b). IDB Group has been working on a solution that could simplify the sukuk issuance process and respond to the lack or fragmentation of sovereign assets (IFN Corporate, 2016a; Business Today, 2016).

IIFM was founded in 2002 as a neutral and non-profit organization with the purpose of making standardization efforts regarding the Islamic products, structures, contracts (documentation), and related processes (Alexakis and Tsikouras, 2009:94; Safari et. al., 2014:104). ICMA and IIFM have been planning to collaborate to develop standardized documentation and sukuk practices. The two institutions' collaboration plan is on establishing a working group to develop standardized contracts, language, and practices for secondary market transactions and standardized practices in sukuk trade and other Islamic financial products (ICMA, 2007). IIFM has carried out extensive analyses on the standardization needs for sukuk through consultative meetings (Reuters, 2016). For example, in 2014, IIFM organized an industry consultative meeting, which was attended by a diverse group of experts, on sukuk standardization. These negotiations have provided a clear roadmap to IIFM on developing guidelines and standardization of sukuk al ijarah structure on the priority basis (IIFM, 2014:1-2). On the other hand, in order to provide a clearer understanding and a level playing field, IIFM will be embarking on a sukuk standardization initiative. However, in the short-term, IIFM will be looking forward to bring out comprehensive guidance notes, so that, the market will have a clearer understanding of the product and its conditions (Reuters, 2016).

Mainly, DIFC is not established with standardization purposes; however, it has projects to create standardized sets of documents for sukuk issuance (Standard and Poor's, 2010:7).



### **3.4. Recent Developments in Standardization**

Although there are many differences in the opinions of the scholars on the subject of Sharia rulings, there also has been a growing trend of convergence in the ideas regarding Sharia, recently (Amundi, 2012:3). In this regard, although standardization has been happening, it has not reached to the market-desired speed. For example, legal documents on sukuk issued by Luxemburg closely resembled those used in the South African government's sukuk issuance procedures. In Asia, the legal documents on sukuk issued by Malaysian government resembled those used by the Hong Kong government (Damak, 2016a). In 2010, Cagamas, the Malaysian national mortgage company, offered sukuk with a structure that was unusual in Malaysia, however, it was designed to pass muster for Gulf investors (Oxford Business Group, 2010:98). On the other hand, IMF encourages the GCC governments to integrate sukuk issuance into their debt management strategies (IFN, 2016).

Experts of the sukuk market expect standardization to be reached in the near future. Since they see evidence of convergence in some of the issues, the World Bank experts have a positive approach on the probability of achieving the standardization (CAIA, 2014). According to S&P, the inconveniences and difficulties that are having been seen over the past few years may, paradoxically, help the standardization process to develop (Oxford Business Group, 2010:97). Ashar Nazim, MENA Islamic Finance Services Leader at Ernst and Young in Dubai, says that there has been a progress in standardization on national and regional basis (Philstar Global, 2012). S&P's Mohamed Damak forecasts greater standardization will be reached within the next three to five years, with multilateral organizations like the Islamic Development Bank's efforts to establish a template for issuance; and recent sukuk deals across countries have been showing larger analogies (Barnato, 2016). According to Damak, this will spur the sukuk sector to reach new heights and attract an even greater variety of issuers, who are eager to tap this lucrative new market (IFN Corporate, 2016b).

Finally, it can be said that as long as the flows of trade between different regions grow, the standardization will be achieved. This is because; issuers who want to tap into different markets will have to issue more standardized sukuk.

### **3.5. Advantages of Standardization**

While standardization can help increasing certainty among industry players, develop the sukuk market, reduce transaction cost, encourage the development of secondary market and liquidity, and provide greater pricing transparency, the sukuk market can benefit from the advantages offered by standardization (ADB, 2014:43).



### **3.5.1. Developed Sukuk market**

The lack of standardization is a major impediment to further development of the sukuk market (Al-Sayed, 2013:71; CAIA, 2014; Mahmoud, 2016). It is well known that the sukuk market suffers a lot from the shortages in the sukuk supply. The lack of standardization hinders sukuk supply growth, and hence the sukuk market development (Muhammad and Alvi, 2010). And, lack of standardization hinders tradability of sukuk structures in secondary market. Because of the lack of standardization in sukuk structures, some of them are not tradable in all states and organizations. On the other hand, issuers would like to issue more standardized and tradable sukuk structures such as ijara sukuk. Therefore, since the diversification in sukuk structures couldn't be achieved, the development of the sukuk market has been thin in recent years (Ulusoy and Ela, 2016:354-355).

As a result of the pronouncement of AAOIFI in 2008, the sukuk market has been negatively affected. It is because of the fact that people were confused about which opinion is right and which one is wrong (Haider and Azhar, 2010:42). Issuers have avoided musharakah nad mudharabah sukuk because of controversies about these structures; and therefore, sukuk issues have started to decline considerably. This might be attributed to the global financial crisis, however, the main culprit was the statement of AAOIFI (Standard and Poor's, 2010:6-7). Hence, lack of standardization in sukuk structures affected sukuk issuances; and the development of the sukuk market slowed down (Ahmad et. al., n.d.).

In this respect, standardization in sukuk structures can encourage the development of the sukuk market (Azhar, 2013:220; Barnato, 2016; Damak, 2016b; El-Quqa et. al., 2008:20; Standard and Poor's, 2010:6-7). This is because, uniformity of documentation and Sharia interpretation can help decreasing the issuance costs, increasing secondary market and tradability of sukuk structures, encouraging sukuk issuance and diversification in sukuk structures. Thus, standardization is an important opportunity for the development of the sukuk market and to put the industry back on a strong growth path (Albawaba Business, 2016). Rapid solutions to the standardization problem will assist the transparency and development of the sukuk markets (Ariff et. al., 2012:213; Hanefah et. al., 2013:118).

### **3.5.2. Certainty among Industry Players**

The sukuk market suffers a lot from the discrepancies in Sharia interpretation of sukuk. Due to different views among Sharia scholars about sukuk, a Sharia compliant sukuk



in one country is not always regarded as compliant in another one (Rohmatunnisa, 2008:2). Thus, investors have to perform with the due diligence on sukuk structures and review all of the related documentation (ADB, 2014). In this regard, investors have to consider each structure about whether it is a Sharia compliant or not. Since risk characteristics and legal structure of sukuk can vary from deal to deal, sukuk investors need to understand the risk return profile, irrespective of the type of sukuk structure used (Moody's, 2009; Thornhill, 2009). Uncertainty in the sukuk market regarding Sharia compliancy possesses risks for the investor protection (Kusuma and Silva, 2014:11). For example, a default case must be resolved pursuant to the standardized legal documentation (Kashoogie, 2011). On the other hand, uncertainty in the sukuk market can affect investors' confidence negatively. As a result of these, the sukuk market has not certainty about Sharia compliancy of sukuk structures (Amundi, 2012).

On the other hand, as the result of the uncertainty in Sharia compliancy of sukuk, issuing some of the sukuk structures can have difficulties. For example, in October 2011, Goldman Sachs Sukuk wanted to issue \$2 billion sukuk, but could not do so due to the different points of views of Islamic jurisprudences in the market (Bukhari et. al., 2014:1699). As a result of this uncertainty, most of global sukuku were adopted to common sukuk structures such as ijara sukuk because of its flexibility and more standardized documentation (Amundi, 2012; Cobanoglu and Aydın, 2016).

Additionally, uncertainty results in a low level of sukuk issuance (Rohmatunnisa, 2008). Investors refrain from investing and trading sukuk that are not recognized globally. Thus, the secondary market of sukuk has always been thin.

Industry players are aware of this the standardization problem (Ariff et. al., 2012:213). The majority of industry players agree that, a guiding set of principles should be established for future sukuk issuances. Increased standardization stabilizes global Islamic debt capital market and safeguards the investor confidence (Annuar, n.d.).

Finally, standardization can increase certainty in the sukuk market by reducing the effort required to analyze structures and documentation; so, standardization will be able to lower the transaction costs, make it easier for participants to understand the products, evaluate risks and returns, and decrease potential disputes about compliance with Sharia (Gelbard et. al., 2014:6; Safari et. al., 2014:150; Stevens, 2013:5). On the other hand, improved standardization across the sukuk market can encourage issuer

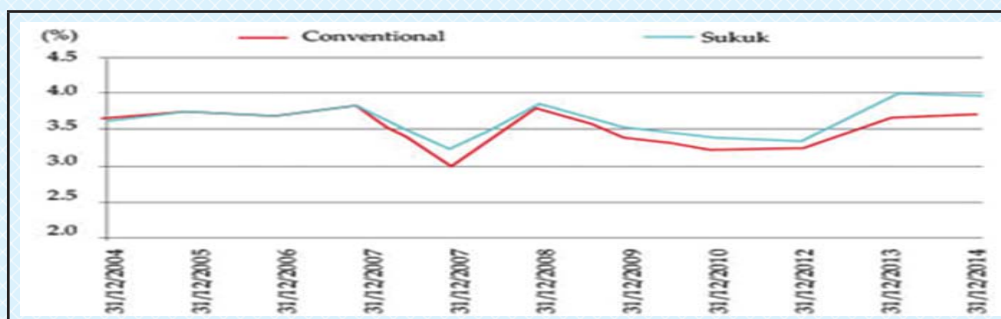


confidence. According to Bashar Al Natoon: “A transparent framework that investors, issuers and scholars are all comfortable with and which makes the rights of all the stakeholders clear, should help attracting a significantly wider investor base.” (IFN Corporate, 2016c).

### 3.5.3. Lower Issuance Cost and Time

Because of lack of standardization, issuance costs of sukuk structures can be higher than conventional bonds (Al-Sayed, 2013:73; Nanaeva, 2010:35; McAughtry, n.d.; Mohieldin, 2012; Standard and Poor’s, 2010:6-7). In this regard, lack of standardization increases the premium for sukuk issuance over conventional bonds. According to Figure 1, sukuk yields are higher than the conventional bonds because of lack of standardization (Damak, n.d.).

Figure 1: Malaysian Government Five-Year Sukuk and Conventional Bond Yields



Source: Damak, n.d.

On the other hand, sukuk has a complicated process to be issued. An issuer that wants to issue sukuk must make an effort which can last several days, months or even years (Damak, 2016a). Hence, it is still more time consuming and complex to tap the sukuk markets than to issue a conventional bond (Business Islamica, 2016). For example, IFC Hilal Sukuk took three years to be issued (Nanaeva, 2010:36).

Requirement for a longer time, more energy, and higher costs make sukuk issuances ineloquent compared with bonds issuances (Damak, 2016a). For example, according to Canadian finance ministry spokesperson who aims to issue sukuk: “The increased cost would be inconsistent with our objectives of rising stable and low cost funding to meet the government’s financial needs.” (Reuters, 2014). As a solution to this problem, standardization could help attracting new issuers by reducing costs and time required for the sukuk issuance (Damak, 2016a; Standard and Poor’s, 2014a:20). In



fact, we have recently been seeing that greater standardization has been accelerating the issuance in the global the sukuk market (Stubing, 2015).

Standardization is a solution to higher premiums and issuance costs (Standard and Poor's, 2010:7; Standard and Poor's, 2014a:20; Standard and Poor's, 2014b:4). As structures are increasingly standardized, we have been seeing a narrowing of the difference between sukuk and conventional bond pricings (Standard and Poor's, 2015:5). On the other hand, standardization can reduce the costs of evaluation and negotiation of documentation (Alvi, 2012). In this regard, it can be said that standardized documentation would reduce cost and time (IFR, 2009; Thornhill, 2009). Standardized sukuk documentation and Sharia interpretation may help decreasing the premiums (IIF, 2014; Stanadard and Poor's, 2014a:17). According to S&P, it is anticipated that premium rates for sukuk over conventional bonds would decline, if sukuk documentation would have been standardized higher (Chesler, 2016). Increase in the sukuk issuances is expected following standardization. (Damak, 2016b; John, 2016). Standardization can increase the demand on sukuk too; because, investors would also consider through standardization that their investments are complied with Sharia (Damak, 2014a). This means that standardization will make the sukuk sector easier to access and the processes will be simpler to use and understand (IFN Corporate, 2016b; McAughtry, n.d.). Hence, standardization can make issuance costs lower (Standard and Poor's, 2010:7).

#### **3.5.4. Strong Secondary Market**

Sukuk secondary market is thin because of lack of standardization (Al Fares, 2010:108; World Bank, 2014:10; IFR, 2009). As sukuk is a Sharia compliant instrument, it tends to have limited liquidity by nature. This is due to the fact that the trade of some sukuk structures is not allowed by Sharia rulings. For example, the sukuk that result in a debt obligation, such as in the case of murabaha sukuk and salam sukuk, cannot be traded at par (Karbani, 2015). Therefore, these sukuk structures are not traded in the sukuk markets except Malaysia. Thus, for example, murabaha sukuk and Bai Bithamin Al Ajil sukuk are only tradable in Malaysia (Thomas, 2007). In this regard, different interpretations on Sharia allowance create segmentation in markets (Kusuma and Silva, 2014:9). Hence, as the sukuk investors are confused about which sukuk structure is Sharia compliant (Rohmatunnisa, 2008:2); they try to buy and trade sukuk only in their own jurisdictions (Ahmed, 2007b). As a result of this, sukuk trade cannot reach to a global dimension.

Because of the lack of standardization, sukuk risk characteristics and issuers' credibility may vary from deal to deal (Kusuma and Silva, 2014:9). This prevents investors



from knowing what risks they undertake when they invest in sukuk (Ahmed, 2007a; Ahmed, 2007b). On the other hand, sukuk investors do not want to replace their sukuk with another issuer's because of the differentiation in credibility of the issuers. Thus, investors want to keep their investment positions and keep their sukuk away from trading.

Standardization is the key contributory factor in the strong secondary market (ADB, 2014:43; Jobst et al., 2008:11; Alvi, 2012; Brugnoli, 2008:24; Farook, 2010; Gelbard et al.). We expect that the future standardization will improve global trading of sukuk and investors will trade sukuk in all states. Additionally, with standardization, the investors' confidence will increase and sukuk trading will be strong in the near future.

#### **4. A Solution Proposal**

Lack of standardization is an impediment to further development of the sukuk market. Although some international regulatory bodies such as AAOIFI have been making efforts to standardize documentation and Sharia rulings; the standardization has not been achieved yet.

There are two recommendations in the literature for standardization. First, it is essential for every country to have a central Sharia board to give clear guidance on which financial products are Sharia compliant to investors (ADB, 2014:43; Kaseb, 2010:8). This is because, as a first step, countries shall achieve standardization in their own jurisdiction systems.

Secondly, it is essential to establish a unified international Sharia board to guide the sukuk market following the standardization in countries (Al-Amine, 2008:17; Muhammad and Alvi, 2010; Goud, 2010). The new Sharia board shall not take over the role of existing Sharia boards. Instead, the new institution shall have the objective of coordinating the efforts of Sharia boards of countries and financial institutions. The new board shall set up Sharia standards, revise existing standards and provide adequate Sharia supervision and governance in coordination with countries (Al-Amine, 2008:17). The new institution shall contain experts from different Islamic schools of thought (Azhar, 2013:222). In this way, unified and international Sharia board can provide convergence in the sukuk market, reduce ambiguity, expedite process, boost investors' confidence, and create wider investor-base globally (Hanefah et al., 2013:118).

We can add that although some international regulatory bodies have issued sukuk standards, they are not binding. For this reason, standards issued by the new unified



and international Sharia boards shall be binding globally. On the other hand, some mechanism needs to be worked out to get the Islamic banks and financial institutions to abide by the standardized products, preferably by the force of law; but if not feasible, then by blacklisting the non-abiding banks (Abozaid, 2016:225). We expect that, by this way, standardization in the sukuk market will be achieved faster.

## **5. Concluding Remarks**

Islamic finance has been rapidly growing in the recent years. Similarly, as one of the rising stars of Islamic finance industry, the sukuk market has also been developing very fast. This is because sukuk demand has been rising globally; and not only Islamic investors and issuers show interest in the sukuk market, but also conventional ones are involved. Although the sukuk market has been supported by legal and taxation regulations made by countries, the demand is very high on sukuk, and etc.; the sukuk market has not reached to its peak level yet. Because, the sukuk market has a lot of challenges such as shortages in sukuk supply, the thin secondary market and the lack of standardization in Sharia rulings and documentation of sukuk structures.

Lack of standardization has been affecting the sukuk market negatively. Since they are confused about which sukuk issuance is Sharia compliant, investors refrain from investing and trading sukuk. On the other hand, as a result of lack of standardization, issuers consider that sukuk issuance costs are very high and then they avoid issuing sukuk, too. And consequently, the sukuk market has not realized its potential yet.

Since lack of standardization is a big impediment to further growth of the sukuk market; we proposed local Sharia boards and a unified-international Sharia board as a solution to the standardization problem, in the study. This is because of the fact that some countries have not got a central Sharia board yet, and thus, they have not been making an effort in the direction of standardization. Hence, before realizing the standardization globally, the first step must be achieving standardization in every country. Following the achievement of standardization in countries, it is essential to establish a unified-international Sharia board. Although there are some international regulatory boards that issue standards, there are certain divergent interpretations even between these standards. Therefore, the sukuk market needs a unified-international Sharia board to guide the sukuk market and issue sukuk standards.

Following standardization in sukuk; we expect development and certainty in the sukuk market, lower issuance costs, and strong secondary market. With that being the case, standardization will be a contributory factor to the sukuk market in reaching the peak level.



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