

Secondary market of Sukuk: An overview



LIQUIDITY MANAGEMENT

By Raghu Mandagolathur

Sukuk are useful instruments, both for issuers as well as investors. They can be an alternative source of funds for governments and conventional institutions, a liquidity management tool for Islamic banks and institutions whose investments must be Shariah compliant and a source of portfolio diversification for conventional institutions.

However, in order to benefit from the advantages of Sukuk, the primary and secondary markets need to be very active. In reality however, the Sukuk secondary market is very weak, hindering its growth prospects. The low level of secondary market activity makes issuing Sukuk very expensive.

Expensive issuing costs can make issuers reluctant to issue Sukuk. The low number of issuances limits the investment opportunities for Islamic institutions, mainly Islamic banks which may then find managing liquidity challenging.

Some of the main reasons for a weak secondary market are as follows:

- **Shariah restrictions**
Restrictions on tradability in the secondary market come fundamentally from a Shariah ruling by the OIC, which states that for tradability of Sukuk in the secondary market in accordance with Shariah, Sukuk should represent a direct link with physical (underlying) assets, instead of denoting debt.
- **Lack of standardization**
The lack of standardization is a major impediment in the further development of the Sukuk market. The lack of standardization in documentation and Shariah interpretations among Islamic nations makes issuance costs of Sukuk structures higher than conventional bonds. Sukuk structures that are considered acceptable in one market may not be equally accepted in another jurisdiction. Gulf-based Shariah scholars have rejected certain structures used in Asia, a region that has proven to be more flexible in its

transactions. For example, transactions involving the purchase and sale of debt contracts in secondary markets are permissible only in Malaysia as Gulf scholars do not accept the debt-based contracts as tradable.

- **Scarcity of supply**
Sukuk structures require extensive and costly legal and religious advice, which adds to the time it takes to issue Sukuk. Sukuk have a complex structure with ownership and transfer of assets and an SPV. Therefore, a restriction on the SPV or transfer and ownership of assets hinders the issuance of Sukuk. Moreover, Sukuk have higher yields than conventional bonds, which further hinders potential issuances. Sukuk also require special tax regulations. The tax and regulatory frameworks of some countries provide for a level-playing field between Sukuk and conventional bonds; however, some countries have not adopted Sukuk-specific legal and tax regulations yet. Because of these challenges, many entities shy away from issuing Sukuk.
- **Hold-to-maturity culture**
Given the scarcity of supply of Islamic liquidity management instruments, Islamic institutions (particularly Islamic banks) have excess liquidity and lack opportunities to invest. On the other hand, due to a lack of products in which to invest their money, Islamic financial institutions are finding it increasingly difficult to manage short-term liquidity. Sukuk have therefore become a more attractive investment tool for these institutions. However, in Sukuk secondary markets, investors prefer to buy Sukuk and hold until maturity rather than trading as it becomes difficult to find another Sukuk with a similar quality to replace the one they intend to sell.
- **Inadequate trading platforms**
Trading platforms are a key contributory factor in the active secondary market. However, Sukuk trading platforms are not evenly developed in all countries. Moreover, trading platforms also have local restrictions, creating a further lack of standardization in Sukuk trading platforms. In Malaysia for example, Sukuk trading platforms are well

developed, but secondary Sukuk market trading platforms in the GCC are limited only to Bahrain, Dubai and Saudi Arabia. Therefore, to achieve increasing supply and active trading in Sukuk, there is a need for well-developed and global trading platforms that provide access to a diverse pool of fixed income investors, generate investor demand and facilitate further liquidity.

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Therefore, solving the problems of the secondary market will develop the primary market, which in turn will help develop the secondary market.

In order to benefit from the potential advantages that Sukuk can offer, there needs to be increased corporate and sovereign Sukuk issuance; market standardization in interpretation and issuance; more rated and listed Sukuk; and additional issuance to retail investors.

There is also a need for large global Islamic banks and dedicated traders who will provide bid/ask prices on a continuous basis. The implementation of these proposals can help investors and issuers take advantage of Sukuk extensively. ☺

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