Kingston University London

Economics Discussion Papers 2016-7

SUKUK: A POTENTIAL FOR STABILITY AND DEVELOPMENT IN THE GCC

Safiyah Taoual

Kingston University
London, UK

8 April 2016

Abstract

This paper explores the significance of Islamic Sukuk instruments for stability in the GCC. As a result of the financial crisis of 2007-2008, interest in financial stability has increased. Islamic scholars suggest that Islamic financial institutions and products have the potential to contribute in achieving a more stable economic environment. This paper analyses Sukuk, an Islamic financial instrument with both bond and equity traits; and how it can contribute to achieving a more sound and resilient economic environment in the GCC. Findings suggest that Sukuk do have the potential to effectively contribute to the GCC's economic stability; as long as they adhere to the pure Islamic financial principles and avoid trying to be comparable to conventional bonds. Currently, however there appears a heavy reliance on shorter term issuances, along with the majority of issuances in the USD, a heavy reliance on real estate as both a means of financing an underlying collateral in Islamic securitization; elements which could be destabilising especially during destress. The originality of this paper lies in its empirical contribution, as it, for the first, time sets out systematically the characteristics of Sukuk issuance in the GCC region with respect to Sukuk maturity, issuance currency and sectoral distribution. It also assesses the various Sukuk structures and the underlying risks involved; as well as the impact of collateral in Islamic securitization.

Keywords: Islamic Finance; Sukuk; Financial stability; GCC; Development

JEL classifications: E44; L79; O16; P5; Z12

Acknowledgements: Many thanks to Ewa Karwowski for her guidance and support.

Address for correspondence: Safiyah Taoual: Department of Economics, Kingston University, Penrhyn Road, Kingston upon Thames, Surrey, KT1 2EE, UK. Email: S.Taoual@kingston.ac.uk

I. ***Introduction***

This paper represents an analysis of the Islamic form of securitisation **Sukuk** (Islamic bonds). Sukuk are investment certificates with both bond and stock-like characteristics, issued in order to finance the production of tangible assets or trade activities. The main distinction being that a bond represents a contractual debt obligation, where the issuer is obliged to pay interest to the debt holder at an appointed date. In comparison, Sukuk holders each possess an undivided beneficial ownership of the underlying asset, which entitles the holder to shares of revenues generated from the Sukuk asset. (Thomas et al, 2005)

Sukuk, asset backed securities, which represent the Sharia[1] compliant version of conventional bonds; are the second largest product composition of Sharia compliant assets (12%) after Islamic banking transactions (83%). Sukuk have witnessed substantial growth rates in the last few years, as annual issuances of Sukuk have almost tripled from USD45bln in 2011 to USD118.8bln in 2014 (MIFC Annual Sukuk Report, 2015). In addition, the latest popularity has extended to non-Muslim countries, leading to a demand of Islamic Sukuk currently in excess of USD 300bn; with the estimation that global demand is to reach USD 900bn by 2017 (EY, 2015).

Interest in the Sukuk market has surged, as an alternative finance option, from a range of sovereign, national and multinational institutions from advanced, emerging, and developing economies; with the aim to finance investments in a broad spectrum of economic activities and development projects.(Kammer. A et al, 2015)

The main aim of this paper is to analyse the growth of the asset based securities Sukuk in the Gulf Corporation Countries (GCC)[2]. The papers contribution is an empirical one. For the first time, the characteristics of Sukuk with regards to Sukuk maturity, issuance currency and sectoral distribution; are set out systemically. The GCC region represents the second largest issuers in the world of Sukuk after Malaysia with 37.7% and 42.3% of world issuances respectively, as of the 1st quarter of 2015. (MIFC, 2015) This makes the paper important for financial stability and policy making in the region.

---

[1] Sharia compliant means adherence to the Islamic jurisdiction principles from the holy Quran and Sayings of the Prophet Muhammed.

[2] The GCC represents an economic and political union of the majority of the Arab countries in the Persian Gulf. The union includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia (KSA) and the United Arab Emirates (UAE) (GCC, 2014).

It challenges the scepticism suggesting that Sukuk are similar to conventional bonds as well as reviewing Sukuk's stabilising element; arguing that Sukuk do have stabilizing potential if utilised in the right manner. Currently, Sukuk are, however, mainly used by non-Islamic financial institutions with weaker issuances by the other developmental industries.

This paper starts by reviewing the concept of Sukuk, its mechanism, challenges and its potential contribution to stability. In the second section then analyses the developments in the Sukuk markets both internationally and in the GCC . The third section then reviews the stability elements with regards to duration, issuance currencies, Sukuk structures and underlying risks as well as the underlying collateral in Sukuk securitisation. The paper concludes with policy recommendations as to how the Sukuk market can be improved.

II. ***Sukuk an analysis***

1. Sukuk: Definition and Mechanism

The Islamic debt instruments Sukuk represent the Islamic form of investment certificates; which are comparable with conventional bonds. The former are in conformance with Sharia principles and provide an alternative source of financing especially for large corporations and sovereign entities. (Alam et al, 2013; Godelwski et al, 2013) Over the last couple of years the global Sukuk market had steadily grown, as annual issuances approximately tripled from USD45bln in 2011 to USD118.8bln in 2014 (MIFC, 2015).

Sukuk are "investment certificates with both bond and stock-like traits, issued in order to finance the production of tangible assets" or trade. (Godelwski et al, 2013, p746) Much like bonds, Sukuk have a set maturity, whilst holders are accredited a consistent stream of income over the life of the Sukuk along with a final principle payment at maturity. In addition, Sukuk represent a bear profit coupon that can be traded at a normal yield price. (Godelwski et al, 2013, Zakaria et al, 2012)

Yet, contrary to conventional bonds, Sukuk are not debt instruments with guaranteed returns and cash flows; Sukuk do not pay interest[3], as returns on Sukuk are linked to the profit generated through real transactions derived from an underlying real business risk. (Zakaria et al 2012) Sukuk can be compared to a trust certificate with a relative or undivided stake in an asset or a pool of assets. This interest enables the right to the corresponding share of

[3] Paying and receiving interest is prohibited under Islamic jurisdiction.

cash flows, risk and benefits; which are derived from owning the assets. (Godelwski et al, 2013). This is achieved as Sukuk enclose a selection of contracts to construct financial obligations whereas conventional bonds create indebtedness through loan issuances. (Zakaria et al 2012)

While Sukuk structures are comparable to conventional asset-backed securities (ABS) or covered bonds; Sukuk are in most cases "**asset-based** rather than asset-backed, with the underlying asset being necessarily Sharia compliant [4]in both nature and use" (Godelwski et al, 2011, p7); implying that Sukuk must be related to a particular asset, service or project for a set extent of time. Sukuk for example have been used in infrastructure and government projects, with underlying assets such as real estate. (Jobst et al, 2008) On the other hand, Sukuk and shares of stock can be regarded as similar in the sense that returns on both assets are not guaranteed; in addition to both contracts implying ownership claims. However, it's important to note that equity shares represent ownership claims with regards to the company as a whole with no maturity date; whereas Sukuk represent ownership of a particular asset with a set maturity date. (Godelwski et al, 2013)

The Sukuk arrangement consists of three parties: the originator of the Sukuk aiming to raise funds, the Special Purpose Vehicle (SPV) who issues the Sukuk certificates, and the investors who purchases the Sukuk certificates. (Tariq & Dar, 2007)

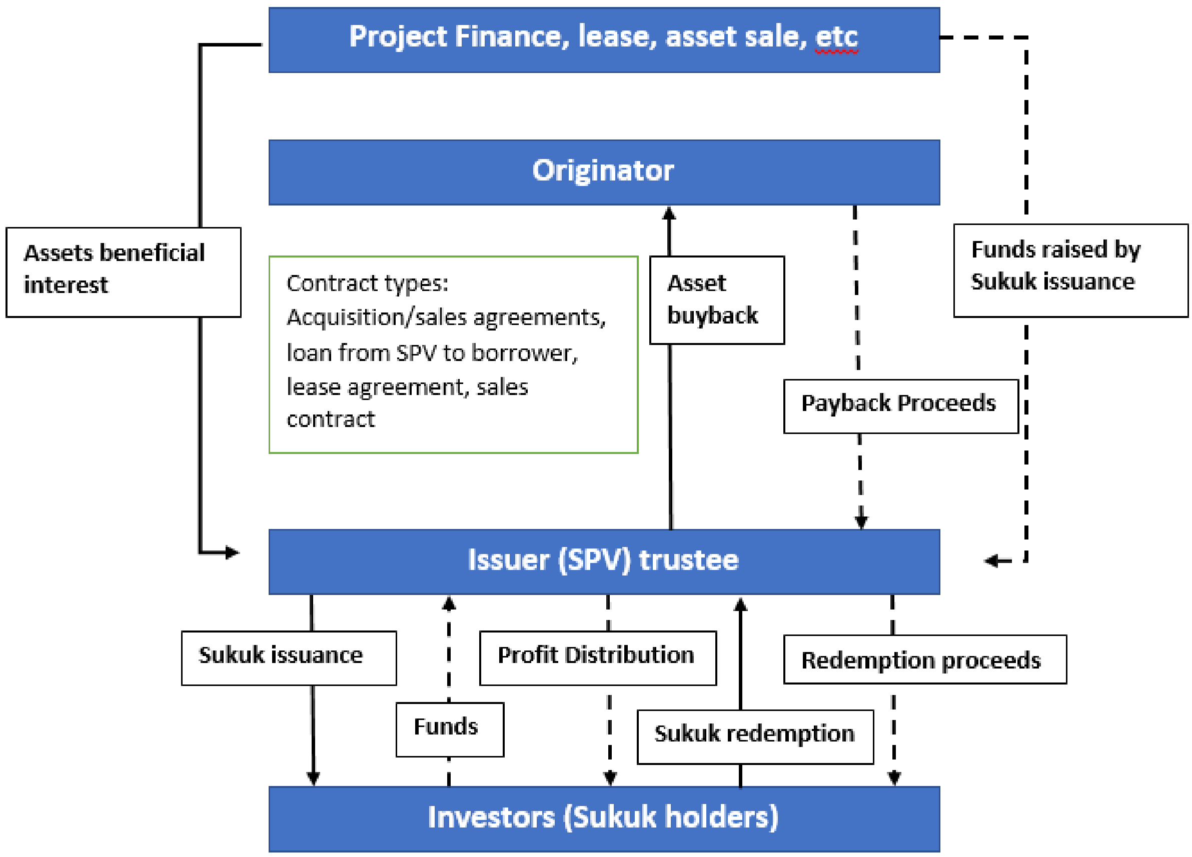
In the basic Sukuk structure, the originator establishes a Special Purpose Vehicle (SPV) through whom Sukuk are issued with the aim to raise funds from investors. The SPV, who represents a separate independent legal entity, acts as the investor's trustee; investing the funds collected in either an asset, project or business, which is provided by the originator. The SPV is also responsible for meeting the payment obligations to investors as they are paid according to the performance of the underlying assets. Then at maturity, the underlying assets are repurchased by the originator, whilst proceeds are applied in order to redeem the Sukuk certificate. (Lackmann, 2015, Tariq & Dar, 2007)

Therefore, the Sukuk issuance procedure can be determined in four main steps:

[4] Sharia compliant financing is based on ethical financing. Under Islamic jurisdiction, it is prohibited to invest in activities such as manufacture or distribution of alcoholic or pork products or pornography. In addition to significant gaming (gambling, including casinos), brokerage, interest-based banking…

1. The establishment of the SPV by the originator (who is raising funds). The SPV then issues the Sukuk to raise the necessary funds
2. The funds raised through the SPV are utilised to purchase the underlying assets from the originator.
3. Any income or profits generated from the assets are delivered to investors according to the agreement set.
4. At maturity the underlying assets are repurchased by the originator and proceeds are utilised for redemption. (Lackmann, 2015)

Figure 1: Basic Sukuk Structure



Sources: Lackmann, 2015

Generally, Sukuk are classified in to two main structures, asset based and asset backed. Asset based issuances are generally referred to as Islamic bonds; whilst asset backed securities are referred to as Islamic securitizations. Sukuk can also come in many contractual forms; the main types are defined in the table 1 in the appendix.

2. Sukuk: challenges and defaults:

In the case of default the Sukuk investors' rights differ to conventional bonds. In the case of a conventional bond default, the issuer can be sued for any missing interest by the trustee of the bond, who acts on behalf of the bondholders. However, with Sukuk the trustee represents the issuer and a special purpose vehicle (SPV). In order to eliminate the risk of the SPV having no benefit in enforcing against the underlying issuer to pay the missed rental payment in the case of default; the SPV delegates all the trustee functions, except for the core holding of the asset, to a professional trustee. This results in a similar trustee used in conventional bonds; who monitors the issuance until maturity. (Mohammed. 2014)

Additionally, for asset-backed Sukuk, in the case of default, the certificate holders, in principle, have resource to the underlying assets provided that all the legal requirements to become a legitimate owner of the assets are established. Consequently, the risk faced by the investors is a market risk, resulting from the risk of capital loss which can occur from a drop in prices of the underlying assets and/or default of the lessee on rental payments. (Lukonga, 2015)

However, Sukuk have been said to possess higher default risk when compared to conventional bonds. This is due to the Islamic prohibition of debt trading; thus making any rescheduling of debt for higher mark-up forbidden. Additionally, Sukuk have been suggested to be limited with regard to liquidity as supposed to conventional bonds, as they, as Sukuk, represent certificates of ownership. This implies that in the case of default, the opportunity for Sukuk holders to retrieve their initial investments is very limited; compared to conventional debt obligations which are very liquid .(Zahamal, 2010, Mohd Noor & Shahimi, 2013)

3. Sukuk and stability:

Similar to the bond market, the dynamism of the Sukuk market also contributes towards enhancing financial stability through its lengthening of the duration of debt; as well as promoting the expansion of inter-regional investment flows. With regards to financial institutions, Sukuk enhance their stability by providing them with improved portfolio diversifications and liquidity. Sukuk acts as liquidity and risk management tools for banks and Islamic Financial institutions, as they enable "the active management of designated asset portfolio due to greater control over asset status, as well as the isolation of certain assets in order to make them self-financing at a fair market rate". (Jobst, 2007, p31)

Similarly, with regards to individual investors, Sukuk are viewed to complement the existing conventional ABS paradigm, through providing an alternative investment product as well as broadening the pricing spectrum, as Sukuk are priced as a result of real market valuation of the underlying assets; whereas bonds are priced given the credit rating of the issuer. (Jobst, 2007)

The risk-sharing feature or what is generally referred to as the Profit and Loss mechanism (PLS) of Sukuk makes them a convenient funding instrument for infrastructure; as returns are linked to profit instead of capital. PLS represents a key element of Sukuk structuring; it's a mutual transaction in which one collection of property rights is exchanged for another, through the purchase and resale of goods as well as the supplying of services; for fees based on an agreed upon contract. This implies that both parties share production, transportation, and different market risks involved; thereby, enabling all parties to enter into a sharing contract that helps reduce the risk of income volatility This helps provide a balance of wealth in the system, which protects it from collapsing. Therefore, as financial integration is increasing along with the internationalisation of Islamic finance, growth in the Sukuk market is set to contribute towards a more holistic growth process whilst enhancing financial stability as the two are mutually reinforcing. (Aziz, 2014) .

Infrastructure projects require complex legal arrangements to insure the sharing of the risks involved as well as the proper distribution of payoffs; as revenue are usually generated years later after the initiation of these projects. The majority of conventional infrastructure projects consist of distinct equity and debt components; which concentrates risk in the equity tranche whilst making the contracts more complex. In addition to limitations when dealing with unforeseen but frequent events such as delays in revenue generation; Sukuk's design enables the broader spread of risk as all investors share risks in the same manner. Sukuk also possess the advantage of their flexibility with regards to the element of time, as returns are tied and generated according to the performance of the underlying assets rather than to fixed schedules; suggesting that they could be issued at different maturities. (Kammer et al, 2015; Ehlers, 2014).

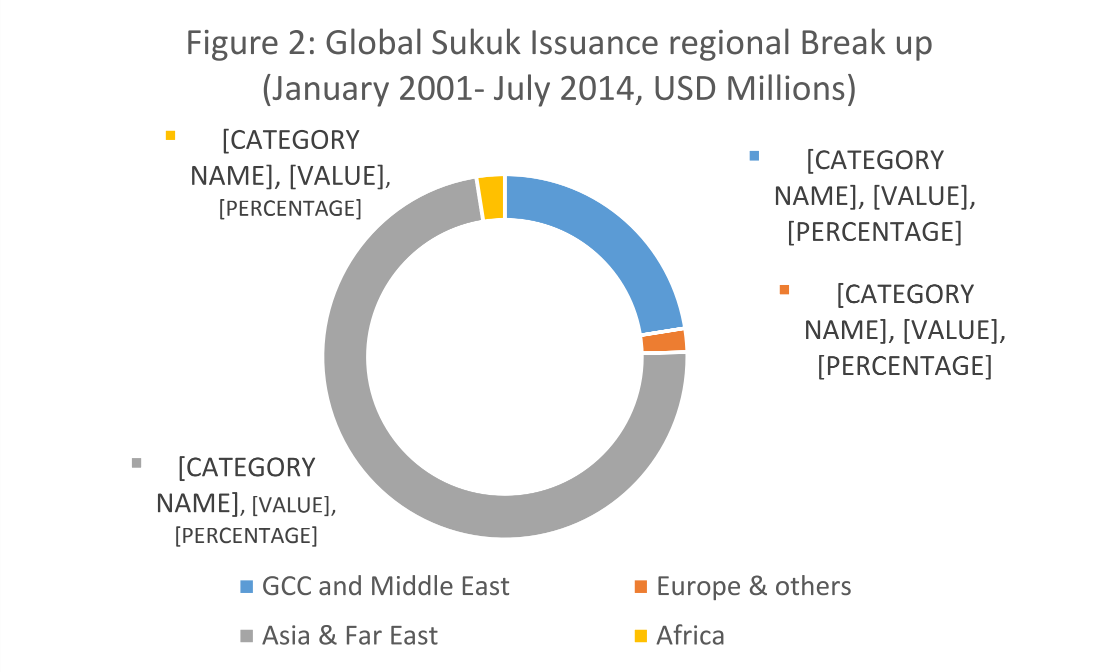
Sukuk distinctive feature lies in their flexibility, as they can be structured according to the requirements and preferences of issuers and investors. (Alawi & Al Quati, 2014) Additionally, Sukuk encourage genuine transactions through which more business activities could take place as they are based on real, identifiable, existing assets. This results in the development of a stable and sound economy; founded on real assets and productive activities as opposed to artificial paper based transactions.

Analysis in this paper will focus on stability elements such as maturity, sectorial allocation of Sukuk issuance, Sukuk structures and the underlying collateral used in Islamic securitisation. Both Maturity and Sectorial view gives a valuable insight as to what purpose the Sukuk as currently being used; which allows to compare the theoretical recommendations of usage vis-à-vis implementations in reality. On the other hand, Sukuk structures and underlying collateral used in securitisation are also interesting, as structures have become more sophisticated, tailored to the various needs and components of the market.

For a financial stable environment, long term maturity bonds are favoured along with projects that support development and productivity growth such as infrastructure and manufacturing. On the other hand focus on the financial sector is regarded as instable. Minsky (1992) , explains this instability as a natural result to the normal functioning of capital economy due to expensive capital assets and a complex, sophisticated financial system. As a result to this complexity, the financial institutions are capable of a number of behavioural trends; which depends upon institutional relations, the structure of financial linkages and the history of the economy. (Minsky, 1985)

III. *Sukuk in the GCC: An analysis*

1. Sukuk market development



Sources : IIFM 2014

Generally, Sukuk issuances have continued to rise over the years. Yet, in 2008, the Sukuk market witnessed a sizable decline; as the former was impacted by the deterioration in the wholesale money markets as well as U.S. subprime mortgage crisis. Sukuk issuances plunged by about 35% on an annualized basis to US$15.2 billion in 2008; while issuances of conventional instruments tumbled down by about 80%, collapsing to just under US$387 billion during the same period. (Jobst, 2010) This decline was primarily notable in the Gulf Corporation Council (GCC) region, as the Sukuk market declined by 59% during 2008 compared to 2007, as it lacked the supportive economic environment. Additionally, the region was impacted by the troubles faced in the regional real estate sector; which was perturbed by the slowdown of global trade and foreign direct investment. (Moody's Investors services, Hijazi, 2009).

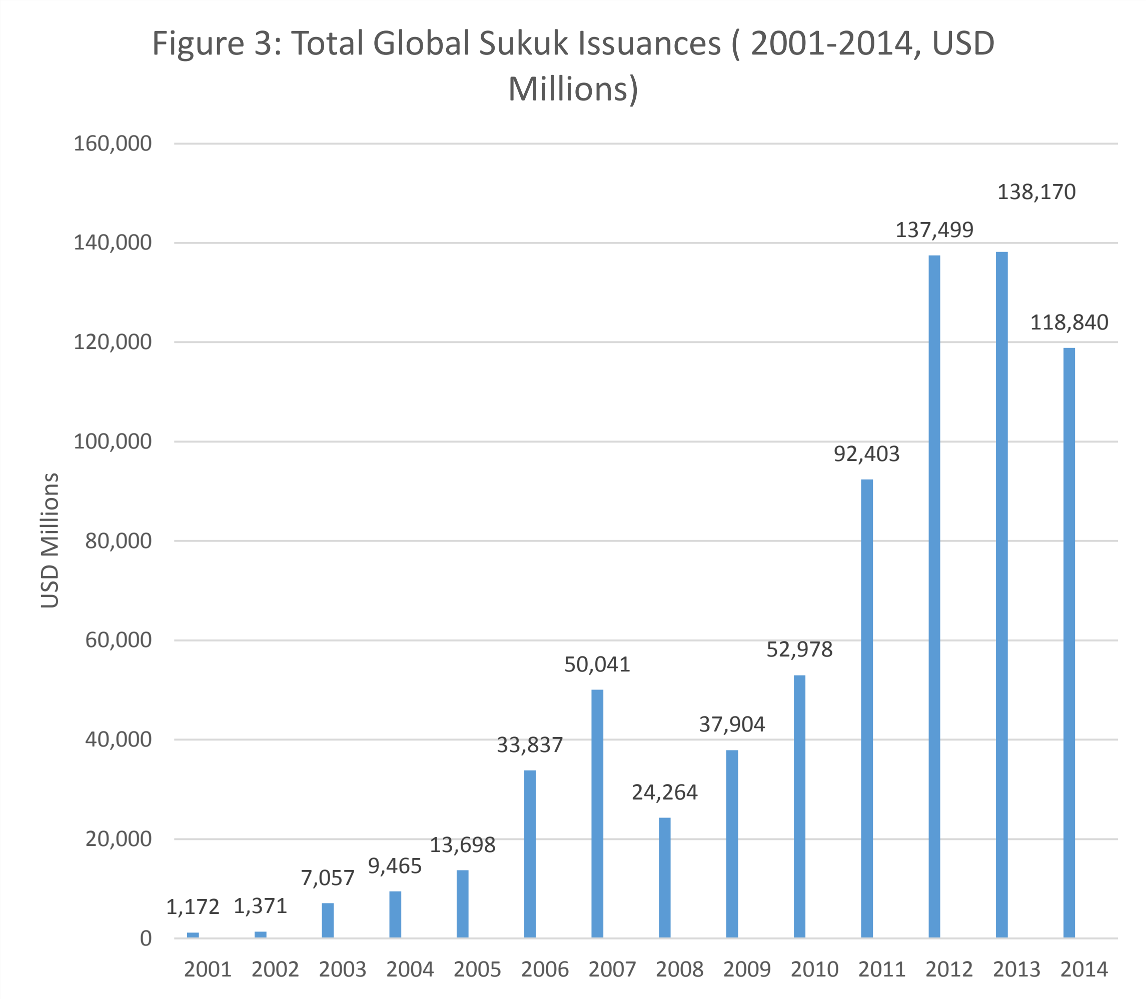
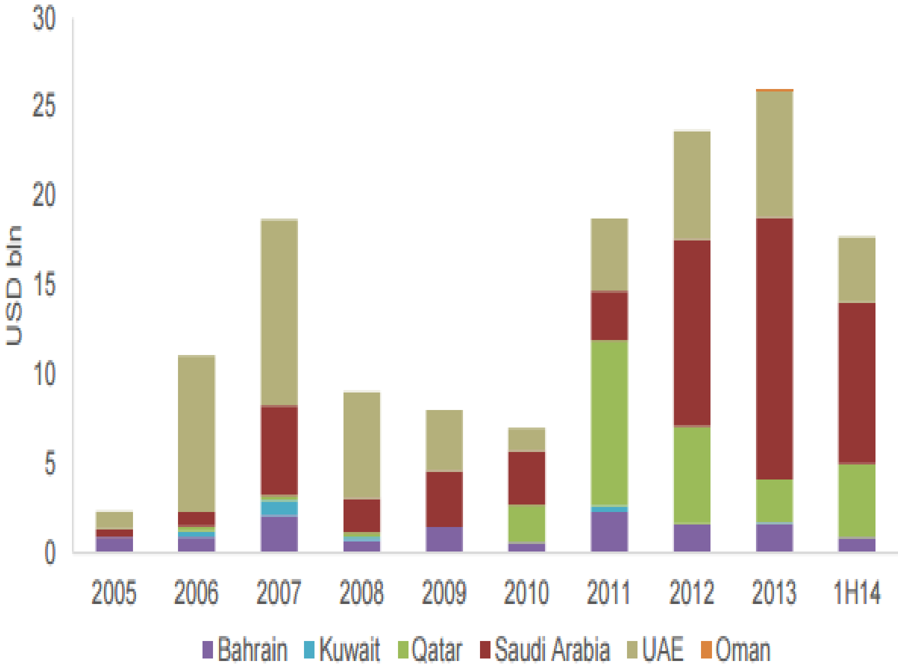


Figure 2 Sources :MIFC/IIFM 2015

But, in 2009, the market picked up its growth pace following the gradual normalization of credit conditions, accompanied by emerging demand which helped stabilize the primary Sukuk market. (Jobst, 2010, MIFC, 2015) The same year also witnessed an increase in cross boarder activity, in the Sukuk market, leading to the rise in the number of issuances in foreign currency Sukuk particularly in USD. The cross-border activity was reinforced as listings on key stock exchanges increased, notably in Europe's stock exchanges specifically the London Stock Exchange and Luxembourg Stock Exchange. (MIFC, 2015)

However, when reviewing the trend of Sukuk issuance in the GCC; it appears that the impact of the financial crisis on the Sukuk market lasted up to 2011, as issuances were relatively low during the years of 2008, 2009 and 2010.

Figure 4: Sukuk Issuance Trend in the GCC



Source: Rasameel, 2014

Nevertheless, the GCC's attraction to Sukuk and Islamic bonds is evident. This attraction is accredited to the extreme change in the Gulf's Debt capital Markets, as well as being underpinned by extremely strong sovereign balance sheets and a demonstrated willingness by governments of the region to support key issuers. Debt Capital Markets in the Gulf have changed dramatically over the last few years. In 2003, the worth of the Middle Eastern Debt Capital market was estimated at 2.7 Billion USD, increased to 38.6 Billion USD in 2013. Many of the Gulf banks such as Qatar National Bank ,National Bank of Abu Dhabi, Emirates-NBD and First Gulf Bank are playing leading roles in arranging bond deals not only in the region but also further afield, as they are starting to compete with the large international banks. This is attributed to the fact that at a macro-level, regional economies have shown consistent growth through several global economic cycles, in addition to becoming stronger as a result of diversification, as well as building strong trade and financial linkages with Asia. (Gifferty 2014)

However, during the period of 2014 - 2015, the GCC's issuances were impacted by the lower oil prices and lower export earnings. Sukuk issuances for the first quarter of 2015 declined to USD18.7bln from USD24.2bln at the end of 2014. Concerns related to exchange rate volatility in emerging markets, influenced by expectations about monetary policy in advanced economies contributed to the decline. (MIFC,2015) Yet, the GCC's Sukuk market future outlook is promising. This is due to the growing utilization of Islamic financial solutions across the key markets such as Saudi Arabia, the UAE and Qatar; to finance the largescale development projects and infrastructure spending planned. (RSF, 2013)

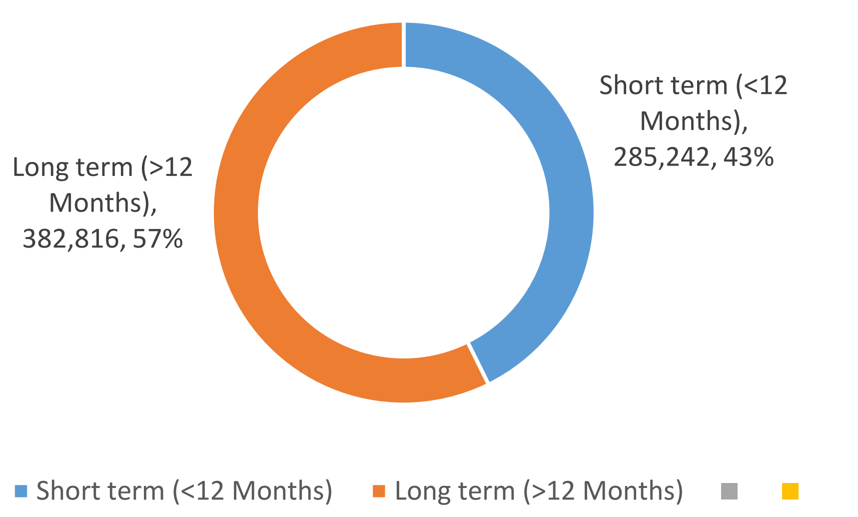
2. Sukuk Stabilizing elements review:

Given the important association of economic and financial stability to currency and maturity mismatches; it is important to ask to what extent Sukuk maturity dates, the development of domestic Sukuk and international markets, Sukuk industry breakdown and the underlying collateral used in the Sukuk securitization have to impacting financial vulnerabilities in the GCC region.

Sukuk are classified in to two main structures, asset based and asset backed. Asset based issuances are generally referred to as Islamic bonds; whilst assets backed securities are referred to as securitizations. The majority of Sukuk issued in the GCC are asset backed with only a limited number of Sharia compliant securitization transactions.

2.1. Sukuk duration: Short term vs Long term Issuences

Figure 5: Comparaison between Global Short term Sukuk and Longer term Sukuk (Jan 2001-July2014, USD Millions)



IIMF(2015)

Global appetite for short term Sukuk (less than 12 months) is evident in the GCC region along with the long term issuances (more than 12 months) .The share of short-term Sukuk market is 43% (USD 285 billion) while the longer term Sukuk issuances is 57% (USD 382 billion) of the global Sukuk market.

The trend towards issuing shorter term Sukuk is rising and is mainly driven by sovereign issuers via central banks issuances; particularly for liquidity purposes as well as supporting monetary policy implementation. This is similar to conventional bonds as the maturity profiles for the GCC Central Bank Local Issuance for both 2012 and 2014, indicated that the percentage of issues under 1 year represented 78% and 65.05%, consecutively, of all GCC central bank issuances (Markaz, 2014).

Market liquidity is regarded as a main concern for Islamic Banks in particular, as the availability of Sharia compliant funds is limited, when compared to conventional ones. Additionally, the lack of properly structured and easily transferable instruments, as well as the obligation of Islamic Banks to maintain higher cash reserves[5] compared to conventional banks; increase the necessity of liquidity.(Archer, Ahmed & Karim, 2014).

Governments in the GCC consider Sukuk essential for developing and strengthening of the Islamic interbank market. The Central Bank of Bahrain is an eminent example, through its regular issuances of short-term Sukuk in Bahraini dinars. (Kusuma & Silva, 2014) Additionally, with the decrease in bank liquidity, increase in volatility, and the increase in demand for public debt; the issuance of Sukuk has become more attractive particularly for cooperate borrowers in the region.

The phenomena of favouring short term borrowing in the GCC, has been explained by Broner et al, (2013) suggesting that the former is due to supply-side factors; arguing that investors, in emerging economies in particular, charge a higher risk premium on long-term bonds when compared to the short-term bonds, making it cheaper to borrow in the shorter term. Furthermore, during periods of financial unsettling the cost of borrowing long term increases significantly, prompting countries to diminish the amount of long-term borrowing. Thus, shorter-term Sukuk have the potential of providing a better yield to investors who have recently been affected by the decline in crude prices which eroded revenue for both

[5] In ISF, banks have real ownership as deposits are determined through real savings implying that there is no credit created without backing it by real savings. Moreover, profits are generated through profit creating activities that generate wealth; this differs to the conventional system where credit expansion has no direct link to real capital. (Askari et al, 2010)

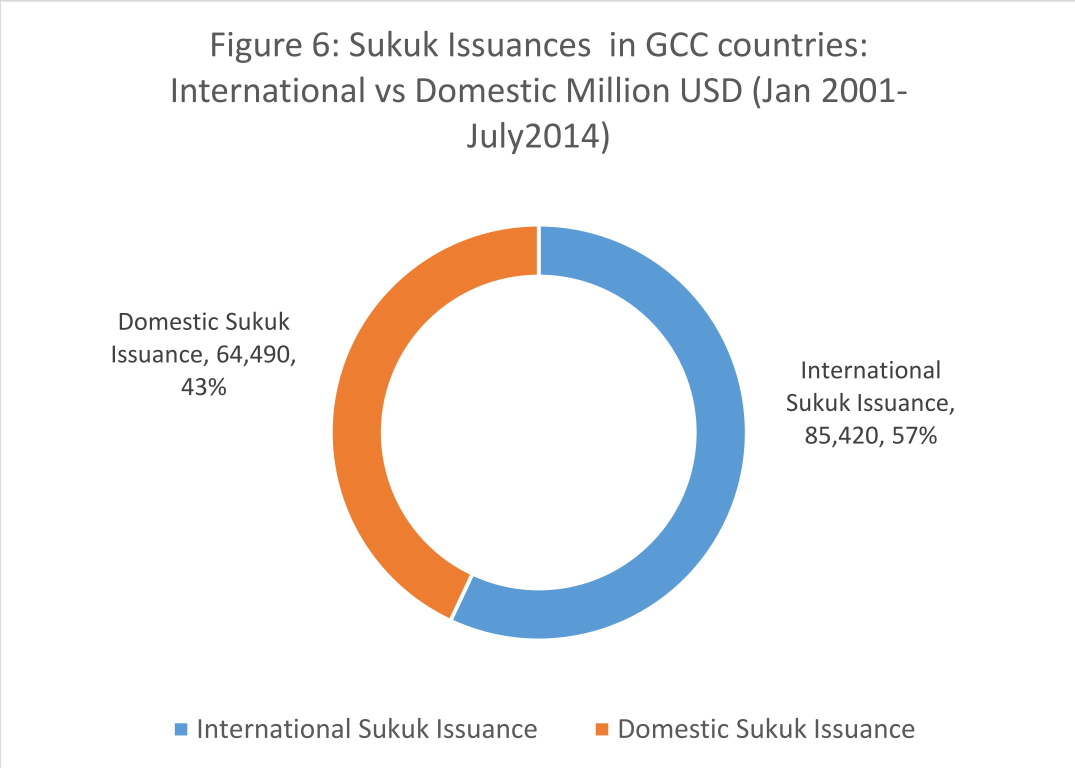
government institutions and bank; all whilst managing interest-rate risk for these institutions through reducing duration (Solovieva, 2015;Broner et al, 2013; IIFM, 2015).

However, although short term Sukuk present a solution to satisfying short term liquidity requirements; the short term maturity trend has its risks and can pose several challenges for banks, financial institutions, pension funds and insurance companies which are trying to match durations of their liabilities in a Sharia compliant manner.

In general, the excessive reliance on short term funding, by financial institutions, has been viewed as the root of fragility of the financial system and the catalyst of the current financial crisis; as many underestimated the probability of a macro shock. In addition, financial institutions were heavily exposed to refinancing risk in wholesale debt markets, resulting in externalities which affect other institutions exposed to short funding. Yet, the rising short-term Sukuk trend can be viewed as an undesirable phenomenon. Kindlberger (2005) argued that heavy reliance on short term financing, particularly with regards to infrastructure, is undesirable as they can be perceived as a sign of distress, and a seasonal tightness which precipitates a crash; whereas long-term financing is central to enabling development because that allows for infrastructure and industrial investment.

On the other hand, the longer term Sukuk have increased in popularity in the GCC region, particularly within in the corporate sector. As we will assess later, the GCC have the distinctive feature of its corporate sector being far more active in Sukuk issuances when compared to 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 market. Yet, though long term Sukuk issuances are increasing in the region, Sukuk issues of 25 years can be described as negligible as the majority of long term Sukuk maturity dates are no longer than 10 years. The only 30 year Sukuk from GCC so far was USD 1 Billion issued by the Saudi Electricity Company in April 2013. (MIFC, 2015)

2.2. Issuence Currencies: International vs Domestic Sukuk issuances:



Sources: IIFM 2015

Table 2: International vs Domestic Sukuk Issuances in the GCC (Jan 2001-July2014)

	International Sukuk Issuance		**Domestic Sukuk Issuances**	
GCC Countries	Number of Issues	Amount in USD Millions	Number of issues	Amount in USD Millions
Bahrain	94	6,830	218	9,124
Kuwait	13	2,127	1	332
Oman	0	0	1	130
Qatar	10	8,935	9	13,115
Saudi Arabia	30	21,542	43	33,538
United Arab Emirates	68	45,986	14	8,251
Total	***215***	***85,420***	***290***	***64,490***

The domestic market represents Sukuk issued in local currencies, whereas International issuances are those usually issued in U.S dollars. The large portion of domestic issuances (43%) serves as an indication to the functioning of the Islamic financial system in the region and its development. Leading countries in domestic offerings were Saudi Arabia ($33,538 Million) and Qatar ($13,115 Million). The raising of funds via the issuance of Sukuk, requires the demand of investors who can either solely invest in Islamic instruments or who have a general preference of Islamic finance compared to conventional financing. This implies the need and importance of developing the Islamic financial sector as Sukuk cannot develop alone; thus suggesting the need for the establishment of basic preconditions for securities market as well as a strong legal and taxation framework in order for the domestic Sukuk market to operate effectively. (Kusuma & Silva, 2014) Hence, the development of a well-functioning Sukuk market requires an effective supporting Islamic financial ecosystem; current trends imply that the GCC countries have and are developing the required enabling environment as well as a genuine motivation for the use of nonconventional instruments such as Sukuk.

Nevertheless, international issuances represent the majority of the GCC issuances with 57% of all issuances. With Bahrain leading in the number of issues (94 issues worth $ 6830 Million); whereas the UAE leads in the amount of its issuances in the international Sukuk markets with ($ 45,986 Million/68 deals) as it has deepened its financial markets over the past decade.

Issuances in domestic currencies are viewed to reduce the overall financial systems' vulnerabilities to external shocks. Similar to conventional bonds; Sukuk are considered to be less likely to default on local currency in comparison to foreign currency. On the other hand, international issuances, particularly ones focused on the short-term paper, enhances systematic risk through undermining the role of monetary policy in the region. During the crisis a large part of government debt and bonds issued as USD-denominated international bonds, faced challenges as international markets dried out and bank liquidity diminished. (Kern, 2014)

However, although domestic Sukuk may be more stable, they can be criticised for their narrow focus on the domestic investors in comparison to international markets. International markets not only provide access to new types of investors, but also a supportive legal framework. Issuers are able to select and use the legal framework, in a jurisdiction that supports the creation of SPVs and issuance of Sukuk that suits them. Many of the Sukuk contracts are enforced in internationally recognized jurisdictions such as the US or the UK. Yet, in the event of default, challenges may arise as Sukuk are asset based; particularly with regards to obtaining local enforcement of a foreign court's decision because of the location of the assets. (Kusuma & Silva, 2014).

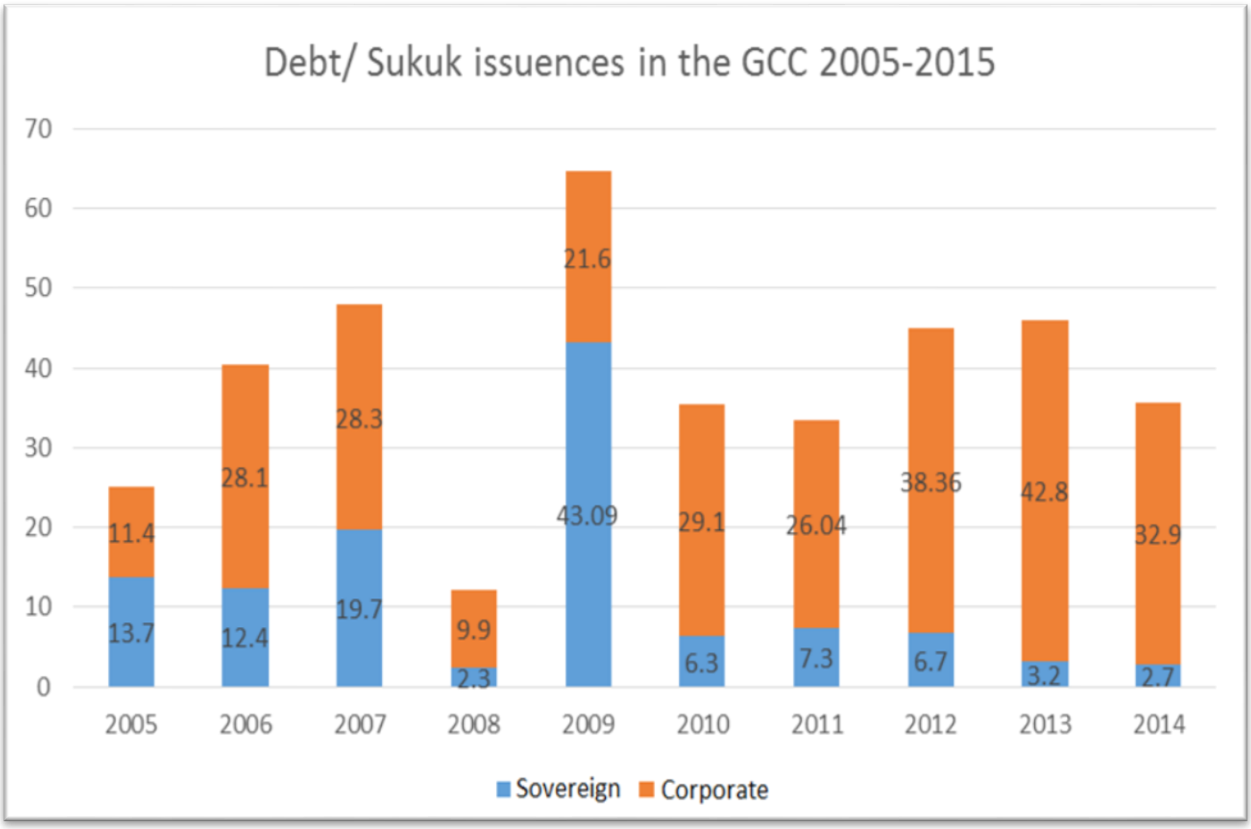
Thus, in order to fully exploit the potential of Sukuk in the GCC, a holistic approach is needed to facilitate the development of domestic markets as well as facilitate the access and operation in the international markets.

2.3. Sukuk issuers Industry Breakdown:

The industry breakup of the Sukuk issuers in the GCC market provides a valuable insight as to what purpose these instruments are used; and whether they are utilised effectively in a manner insuring and enhancing systemic stability and development in the region.

GCC economies are characterised by the robustness of their reserves surplus, meagre debt levels and strong credit profiles. Yet, these economies suffer from their high dependence on oil revenues. This situation, implies a high and significant volatility to variations in international oil prices. (Markaz, 2015)

Figure 7: Debt /Sukuk in GCC 2005-2015

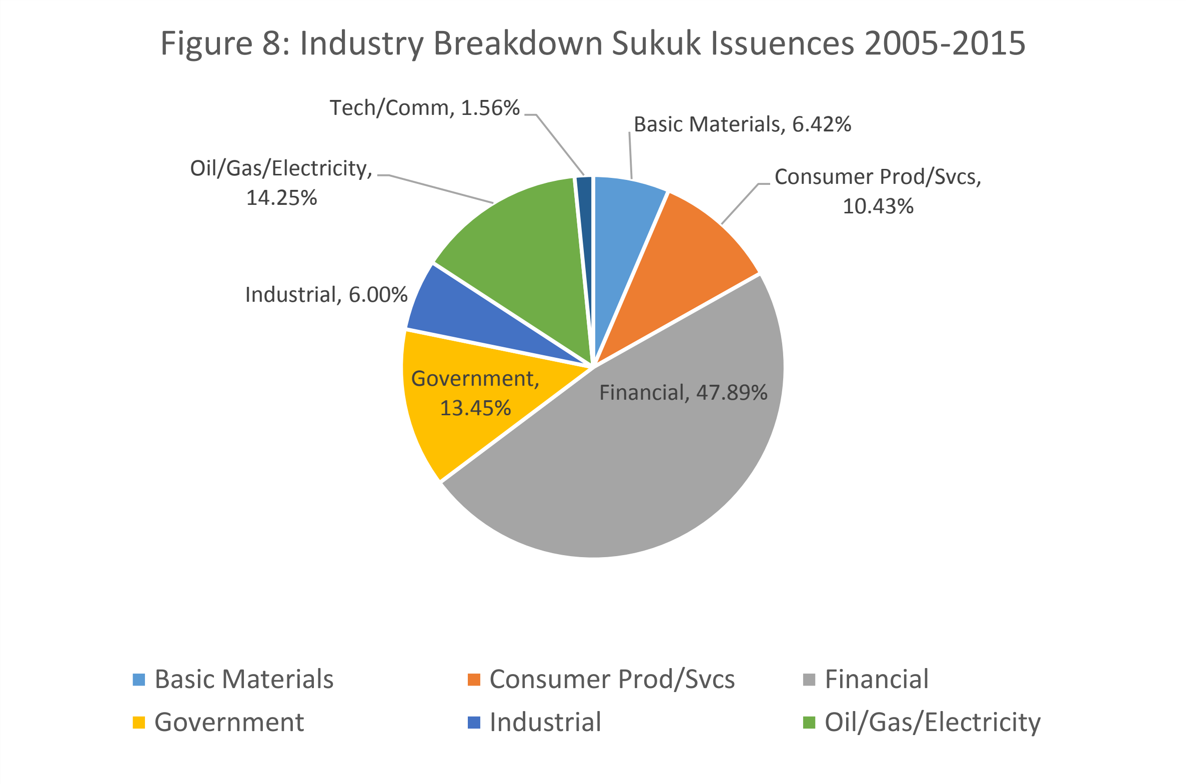


Sources: Bloomberg, Markaz Analysis(2015)

GCC countries have the distinctive feature of corporate issuers being far more active than sovereigns, partly because of the strong fiscal position of some countries in the region. Therefore governments do not necessarily need funding from the capital markets. This is evident from the last 10 year forecast (Figure 7), as corporate issuances have surpassed sovereign issuances for most years except for 2005, when Sukuk were just taking off in the region, and 2009 after the credit crisis of 2007-2008. The collapse of asset and commodity prices and the freezing of financial markets, resulted in the sharp credit slowdown in the GCC .This slowdown prompted forceful reactions by the GCC authorities which included fiscal stimulus, monetary easing, and exceptional measures to support the financial system which included the issuances of sovereign Sukuk to support the region's economies. (Rocha, Arvai & Farazi, 2011)

The government's presence in the debt/Sukuk has a dual impact, positive and negative. A strong government presence in domestic debt markets; can in the case of conventional bonds, contribute to the establishment of risk-free yield curves, which stand as a benchmark for private sector issuances. (Jeaneau & Tovar, 2007) Although issuances of Sukuk can be said to not abide by this rule, as they do not represent debt certificates with a financial claim to cash flows receiving guaranteed returns from a loan; the lack of sovereign presence has been regarded as one of the underlying factors in the slow development of the Sukuk market in the region; as the later can potentially create a pricing benchmark for potential corporate issuances.

Additionally, the limited amount of information from private sources, with regards to securitized assets, in many Sukuk transactions also hinders fair market valuation (Jobst, 2013; RFS, 2013) However, as Sukuk do not pay interest and returns are linked to the profit generated through real transactions derived from an underlying real business risk; viewing government issuances as a benchmark will not necessary be useful as each project is unique in its underlying risk and consequently its return structure.



Source: Bloomberg (2015)

Detailed industry breakdown of Sukuk issuers in the GCC, indicates the strong presence of the financial sector. The industry breakdown compiled by Bloomberg for the period of 2005-2015, also confirms the weak sovereign presence in the Sukuk market with 13.45% of all issuances; whereas the financial sector represents 48% of all issuances.

The strong financial presence along with the weak presence of industries with strong productivity enhancing potential such as Communications, Industrial Utilities and Transport; can pose a challenge to the development and growth potential in the region. The last crisis resulted in the loss of trust in the financial industry and their motives. This leads to the question whether banks (particularly conventional ones) in the region are utilizing the Sukuk as a means to take advantage of the funds rich region.

Although theoretically Sukuk are considered valuable potential particularly with regards to infrastructure, the GCC has witnessed a minimalistic number of project financed via Sukuk issuances. The year 2012 saw the launch of the world's first project based Sukuk by Saudi oil giant Aramco. In collaboration with French oil company Total, Aramco launched a Saudi Arabian Riyal (SAR) denominated Sukuk worth USD 1 billion in order to finance construction of the Jubail oil refinery. The issuance was positively accepted by the market and was followed by a similar Sukuk of bigger size, this time in collaboration with another international giant Dow Chemicals, to fund construction of the Sadara chemical complex in 2013. (IIMF, 2015)

Sukuk analysis criteria by Standard and Poor's rating agency (2012) suggested the following ratings for five of the GCC's main infrastructure Sukuk issuances:

Table 3: Rating of major infrastructure Sukuk (S&P ratings, 2012)

Sukuk	**Rating**
Saudi Electricity Global Sukuk Co..	**AA** [6]
Aby Dhabi National Energy Co. PJSC . TAQA Sukuk	**A-** [7]
PETRoNAs Global Sukuk Ltd	**A-**
Nomura Aircraft leasing Sukuk	**BBB+**[8]
Axiata Group Berhad	**BBB-**

The ratings above demonstrate that the Islamically funded infrastructure is regarded as stable; as its rating fluctuate between having a strong capacity to pay back any financial obligation AAA, and BBB which suggest that they are in a financially stable position to repay their obligations.

The emerging presence of industries with productivity enhancing potential such as Communications, Industrial Utilities and Transport; in the Sukuk market represents a promising potential. The market outlook published by Al Markaz Research (2015) for the GCC, as indicated in the table below (Figure 9), reviews the overall market view with regards to factors such as Oil markets, Earnings Growth potential, Valuation Attraction, Economic factors and Market liquidity. The GCC market outlook 2015 shows the strong correlation between developments in the oil sector and the general economic environment in the region. Thus, with market expectations proving to be neutral or negative for most of the GCC; Sukuk have the potential to provide both short as well as long term financing. Additionally, with market liquidity anticipated to be negative in the region (Kuwait, Oman and Bahrain), short term Sukuk provides the potential to resolve this issue.

[6] AA: According to S&P ratings "an obligor is rated 'AA' has very strong capacity to meet its financial commitments; differing from the highest-rated obligors only to a small degree." (S&P, 2012, p7)

[7] A : "Obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong".(S&P,2012,p7)

[8] BBB An obligation rated 'BBB' exhibits "adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation". (S&P , 2012,p7)

Figure 9: GCC Market Outlook 2015

Title	KSA	Kuwait	UAE	Qatar	Oman	Bahrain
Oil Markets	Negative	Neutral	Neutral	Neutral	Negative	Neutral
Earnings Growth Potential	Neutral	Positive	Positive	Positive	Neutral	Negative
Valuation Attraction	Neutral	Positive	Positive	Neutral	Neutral	Neutral
Economic Factors	Neutral	Positive	Positive	Positive	Neutral	Neutral
Market Liquidity	Positive	Negative	Positive	Neutral	Negative	Negative
Overall Market View	Neutral	Neutral	Positive	Neutral	Neutral	Neutral

Source: IMF, Reuters Eikon, Zawya, Markaz Research

Markaz Research(2015)

2.4. Sukuk structure and underlying risks:

The growing sophistication and flexibility of Sukuk structures, has become a key factor behind its growing acceptance; as they can be customised to meet the requirements and preferences of specific target markets. Over the years, numerous structures have developed. Al Ijarah (Lease agreement) and Murabaha (Cost plus sales agreements) Sukuk are considered the most prominent Sukuk structures due to their general acceptance by diverse Sharia boards as well as their rather simplistic contractual term. Yet, there has been a development of more complex structures, for investment purposes, that involve forms of partnership such as Musharakah (partnership agreement in a specific projector activity) and Mudaraba[9] (.(Hijazi, 2009) .

The lack of standardization and different interpretation of Sharia Law with regards to Sukuk structures has raised challenges concerning the comparability and pricing of these securities. The different structures make the investors' decisions to replace Sukuk from one issuer with another, for a credit reason or otherwise, not straightforward like in conventional securities; thus making it difficult to recognise the risks they are taking on. (Kusuma & Silva, 2014 ; Lukonga, 2015) Yet, in order to avoid these risks investors usually seek products with general agreement to be Sharia compliant. The favoured structure is Al Ijarah Sukuk (lease-based Sukuk) due to its simplicity. Additionally it is approved by all Sharia boards, so it is unlikely to be affected by any changes in Islamic interpretation. The difference in the

[9] A partnership agreement where the funds to finance a project are supplied by the provider of capital; while the entrepreneur offers labour and expertise. Profits ratios are agreed upon and are shared accordingly. However, in the case on loss, all losses are borne by the owner of capital; as the liability of the entrepreneur is restricted only to his time and effort..

underlying structures and their robustness was evident during the 2007-2008 crisis, as the rates of defaults between different structured differed.

Sukuk Al Ijarah represented the most prominent structure for GCC issues in the last few years. Prior to the real estate boom in the GCC, the majority of Sukuk issuances were either Mudaraba or Musharakah; which were used in financing business activities. However, as the real estate market boomed in the region (Dubai in particular) issuances of Ijarah Sukuk increased based on real estate related assets; as they are considered rather secure with better risk profile compared to partnership agreements such as Murabaha. (Goud, 2010)

The crisis of 2007-2008, witnessed several Sukuk defaults in the GCC region. Analysing these cases proves to be particularly interesting as theoretically, Sukuk are similar to equity as they are based on the sharing of both profits and loss (PLS). Therefore, there should be no question of default, in what can be considered as a limited liability/ equity like instrument; along with access to the underlying asset since holders are considered legal owners. (Winjnber & Zaheer, 2013)

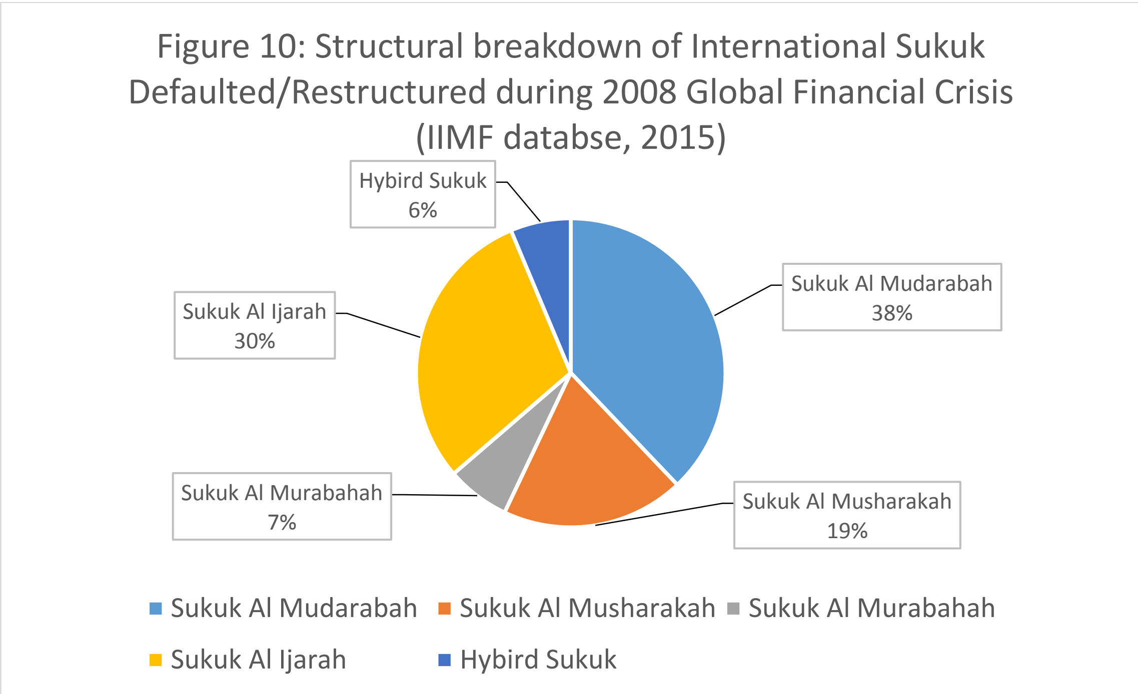


Figure 10: Structural breakdown of International Sukuk Defaulted/Restructured during 2008 Global Financial Crisis (IIMF databse, 2015)

[10]

Source (RSF, Rasameel, 2013)

Analysis of the 2007-2008 crisis, suggested that the most prominent type of Sukuk defaults were Sukuk Al Mudarabah (38%) Sukuk Al Ijarah (30%) and Sukuk Al Musharakah (19%).

[10] A hybrid Sukuk has a more complex structure as it adopts multiple components within the structure such as using element of Wakala and Mudarabah Sukuk together.

Eminent defaults included Kuwaiti Islamic Investment Company, which announced its failure to pay biannual return on its USD100 million Sukuk. This was followed by the default of the Saudi Saad Group, which failed to pay periodic rental payments on its USD650 million Sukuk, issued in 2007. In November 2009, the Government of Dubai announced its failure to make payments on one of the largest Sukuk issued, Al Nakheel Sukuk of USD3.5 billion just few weeks before its maturity. However, this was prevented by a USD 10 Billion bailout package from the Government of the Abu Dhabi. (Zaheer &Van Wijnbergen, 2013)

The defaults proved interesting due to the use of different structures, as well as the fact that many of these Sukuk were asset-based rather than asset-backed. Being asset-based, meant that Sukuk holders could only require the originator to purchase the underlying assets; as well as having an unsecured debt claim against the originator from the payment of the purchase price after exercising their rights under the relevant purchase undertaking. Thus, arguably resulting in an unexpected credit risk to many of the investors; who believed that they would have access to the underlying assets.

However, in 2007-2008, as the economic situation worsened, payment obligations could no longer be met. Many international investors faced difficulties transferring ownership since in some GCC countries it is not permissible under applicable local laws or the transferring process is complicated and an expensive legal and regulatory process. (IIFM, 2013; Lukonga, 2015)

The main issue that occurred was that under the United Arab Emirates (UAE) legislation (Dubai in particular) leasehold interests are not regarded as real rights, or property rights; implying that they are not sale agreements were rights can be transferred. Thus, as leases are not viewed as real property rights; they are considered to be “unregistered personal contractual rights binding the parties as opposed to rights attached to the land in question”. (Salah, 2010, p.32)

The Al Nakheel Sukuk default shocked the Sukuk markets around the world, as it was one of the first billion dollar Sukuk on the verge of default. Issuance of the Nakheel Sukuk was based on Al Ijarah Sukuk structure; similar to the conventional lease-and-lease-back transaction. The underlying tangible assets in the Nakheel deal were the land, buildings, and other property known as DWF South and Crescent Lands at Dubai Waterfront. The project requiring financing was the plan to construct a “city twice the size of Hong Kong Island, with skyscrapers for 1.5 million residents, all ringed by a 75 km canal at Dubai Waterfront. The aggregate amount for the entire lease period of 50 years was paid by Nakheel SPV to Nakheel Holdings” (Salah, 2010, p22).

Nakheel SPV operated as the trustee for and on behalf of the Sukuk holders; with each Sukuk certificate representing an undivided beneficial ownership of the trust assets held by the SPV. However, analysis conducted by Salah (2010) of the Nakheel Sukuk, shows the complexity of its legal structure. Initially, Sukuk holders positions were secure and sufficiently protected; as the various Nakheel holdings engaged in a co-obligor guarantee, which meant that each holding guaranteed the payment obligations of their own and each other's. Proprietary rights were also established in order to provide the holders with property law protections.

When Al Nakheel Sukuk were issued, there was no mention of the formal registration required for leasehold rights. Hence, Sukuk holders in this case, did not acknowledge the UAE and Dubai's complex financial legislation; which considerably impacted on the legal options Sukuk holders faced. (Salah, 2010). As a result, the defaulted cases in the GCC exposed what can be regarded as inconsistencies between theoretical principles of Sukuk products and actual structures; as well as limitations in investors understanding of risks involved.

Yet, it can be argued defaults do not undermine the stability element of the Sukuk, as holders still had link to the underlying assets. Yet this was hindered by the lack of transparency of legal clauses and the rules and regulations of the issuing countries. Thus, highlighting that investors' rights depend on local laws and the jurisdiction where these underlying assets were domiciled, as well as on the strength of legal rights in the country where the collateral is likely to be disputed. The reclaim of portion of ownership, which enables investors to take control over the securitized assets and their operations, was hindered by complex legal and tax proceedings as well as prominent restrictions in the GCC on foreign ownership of locally domiciled assets. (Jobst, 2013, Lukonga, 2015).

However, the main issue with the problematic Sukuk was that they did not follow the pure Islamic notion of transparency when presenting the clauses in the main contracts. Islamically, there should be no discrepancies and loopholes which can deprive the Sukuk investors of the rights promised in the offering circulars. Additionally, Winjnber & Zaheer (2013, p2) suggested that in most cases, "the problems can be traced back to clauses and structures that made the Sukuk more like conventional bonds". These clauses included sections to ascertain the return on capital with some promissory notes or guarantees by the originators or third parties; as well as credit enhancement agreement. Such features made Sukuk very similar to conventional bonds which pay periodic interest and a face value at maturity. As a result, introducing conventional traits put Sukuk in a position in which there were eligible to default just like conventional bonds.

Therefore, strict adherence to Sharia[11] principles of ownership, transparency and risk sharing would have considerably reduced default cases as well as eased the restructuring process; as Sharia law implies a clear allocation of property rights to investors in the case of distress. (Winjnber & Zaheer, 2013). Adhering to these principles would have ensured Sukuk a much resilient position.

Nevertheless, it's important to note that fluctuations and failures in the Sukuk market cannot be viewed inseparably to the global economic downturn during the period of 2007-2008; as well as the collapse of the real estate market which escalated from the US subprime market crisis. Therefore, Sukuk cannot be treated and expected to react in isolation to the external economic environment; as they are subject to the impact of general economic conditions. Similarly, Sukuk are exposed to sectorial and industry specific risks related to whatever it is being used to finance and if that sector or company experiences a downturn. (Goud, 2010)

2.5. Underlying collateral Islamic securitization:

Securitization's main advantage lies in the pooling of idiosyncratic risk and promoting risk sharing across a wide base of investments and investors; as well as transforming assets subject to liquidity and credit risks, such as leases, mortgages or small enterprise loans into tradable instruments with much lower credit risk. (CGFS, 2007) However, the credit crisis of 2007/2008, has prompted a less compassionate view with regards to securitisation. Particular scrutiny has been on the multi-layered agency problems at the various stages of the securitisation process; starting with the origination of the loan to the sale, warehousing and securitisation as well as the role of the credit rating agencies in the process. The multi-layered ownership structure is often described by the means of an inflating balloon which fills up with new assets. As the balloon expands, the banks search for new assets to fill the balloon a well as seeking borrowers to lend to in the meantime. (Shin, 2009)

Yet, the structure of Islamic securitization (asset backed Sukuk) impedes the occurrence of such a situation, as Islamic financial principles require that the end investor has total access or ownership of rights; when conventionally there are numerous layers of ownership. This

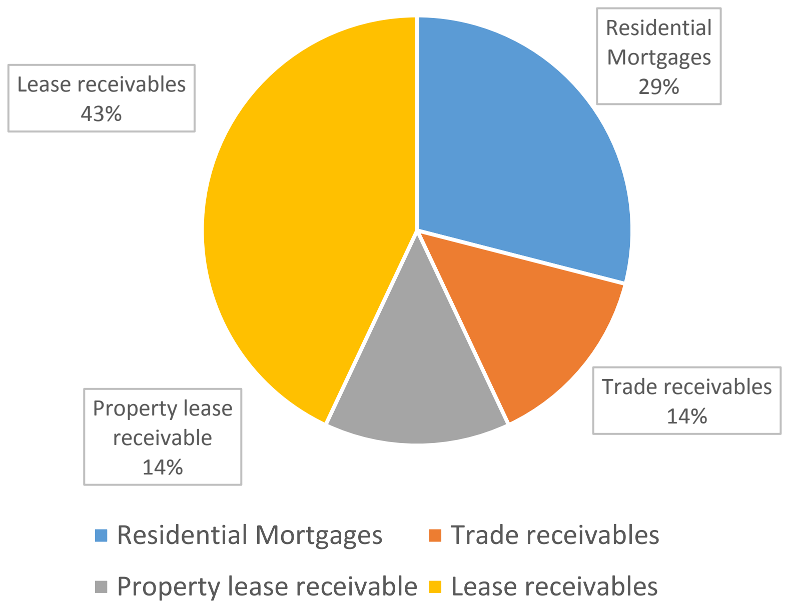
[11] Sharia Law: Islamic Jurisdiction from the holy Quran and Sayings of the Prophet

feature limits the possibility of a security being traded multiply, which could have cascading outcomes in the case of liquidation. (Askari, 2012)

GCC countries have a large potential for Islamic securitization. Islamic securitization has taken a particular keen interest in the real estate sector; as the former is viewed as a real tangible asset class, on which the Islamic financial structures can be easily based. Real estate has had a fundamental role in the Islamic finance industry since the 1990s. Islamic property investments debuted in the residential housing sector then proceeded to commercial real estate and commercial property investments.

In the GCC, most securitised assets are residential mortgages, consumer finance and auto loans; with asset diversification anticipated to increase in the future as the Sukuk market develops further. During the period of 2003-2013, the majority of Islamic securitised transactions originated from the real estate market, counting for 4 out of the total 7 Islamic securitisation deals during that period. These real-estate backed transactions, were transacted in the UAE, KSA and Qatar, along with the single sovereign Islamic securitization structured in Qatar in 2003. In 2013, Kuwait emerged the first innovative Islamic transaction backed from the retail industry. Meanwhile, the single financial institution to issue Islamic securitised instruments was the Islamic Development Bank of Saudi Arabia (IDB) in 2003, as the only bank to issue in the region, potential for this type of transactions is evident particularly with regards to liquidity and developmental projects. (RSF, 2013)

Figure 11: Proportion of Islamic securitization transactions by collateral type (2003-2013)



Sources: (RSF, Rasameel, 2014))

When observing the underlying collateral generating the cash flow of the Sukuk; it can be concluded that the most utilised collateral class is that related to the real estate sector. The two most commonly used assets during the period of 2003- 2013 were lease receivables (43%) and residential mortgages (29%). The collateral underlying the Sukuk securitization, represents a crucial element with regards to the stability aspect of the Sukuk. Adhering to Islamic principles, suggests that collateral assets must be Sharia compliant, this means collateral cannot be debt, or based on any unethical, exploitable, speculative or any prohibited activities. (Jobst, 2013). Therefore, real estate is viewed to be one of the favoured assets classes for Islamic investors as property clearly meets the asset focus of Sukuk transactions. As a result, the majority of underlying collateral is real estate related such as mortgage backed securities, lease receivables, and property lease receivables which are backed by the payments on loans secured by residential or commercial real estate (Lucipa, 1998).

The crisis of 2007-2008, witnessed the leading role of securitization and the real estate market. Thus, the stability of the real estate sector has been one of the prominent topics discussed during and after the latest financial crash; with a widespread argument suggesting that many periods of financial instability in the past were linked to equity or real estate price boom-bust cycles. Consequently, large asset price increases are often regarded as an indication for a bubble in the making; while large price decreases are viewed as an indication of a bubble burst (Helbing, 2003). During the 2007-2008 crisis, the GCC witnessed a sharp fall in its stock prices, which resulted from the burst of its real estate bubble as well as the region's openness to international markets.

Property markets have several distinctive characteristics when compared with other types of assets. The main one being its locality element as that the supply of property is intensively local. Additionally, its flexibility with regards to delivering new real estate properties, is rather limited as the former is constrained by the length of the planning and construction phases. Furthermore, real estate market liquidity is constrained by the high transaction costs. (Helbing, 2003) The real estate market is widely used as collateral in securitization contracts as short sales in the industry are not feasible.

However, the real estate market possesses several inherent risks as investments in the sector rely upon numerous factors, including the type of property as well as independent assessment and review parties. (IFSB, 2009) In the short run, property prices are more likely to diverge from their long-term expectations and forecasts; as fluctuations can arise not only as result from cyclical movements in economic fundamentals, interest rates and the risk premiums, but also as an outcome of the intrinsic traits of the property market itself. On the other hand, for Sukuk based on real estate, risk is likely to be greater for properties under development in comparison to completed ones. (IFSB, 2009; Zhu, 2003)

These factors can pose a challenge with regards to the stability of the real estate sector. Additionally, collateral such as rental agreements and leases, inhere risks of their own. Rental agreements, mortgage payments and leases are strongly correlated to factors based on economic and demographic conditions. (Raja Abd Aziz, 2010) Rents can be very sticky as a result of the use of long-term rental contracts. (Helbing, 2003)

Furthermore, the high reliance on mortgage based collateral is also problematic as mortgage loans default correlation is relatively high which represents a substantial systematic component. Yet, though mortgage loans typically have a lower default probability, defaults in the mortgage market usually come together as the overall national economy falls into distress. (Zhu, 2003) This high correlation is particularly important in the case of Sukuk, due to the lack of diversification in the types of underlying assets; as the fact that Sukuk were biased towards one sector (real estate) made them heavily exposed to the global economic downturn.

IV. ***Findings & Conclusions:***

The increase of regional focus and attraction to Sukuk and Islamic bonds, by both financial and non-financial institutions, in the GCC is evident. The Islamic instruments are being utilised both for shorter term liquidity purposes, aimed at strengthening the Islamic banking sector as well as long term issuances. Yet, the heavy reliance on short term utilisation raises some concerns; particularly as shorter term issuances can be perceived as a sign of distress, and a seasonal tightness which precipitates a crash; whereas long-term financing is central to enabling development because that allows for infrastructure and industrial investment. Thus, growth potential is available for longer term Sukuk issuances as they are arguably more stability enhancing.

The analysis suggested that there is a tendency to issue in US dollars; as international markets prove to not only provide access to new types of investors, but have the necessary supportive legal framework; as the legal framework in the GCC is rather complex. Heavy reliance on USD can be destabilising especially during distress, as international markets dry out and liquidity diminishes; making repayments difficult. Furthermore, the industry breakdown suggest that Sukuk seem to be utilised in a wide range of sectors and numerous applications; which stands as a promising indication.

However, although theoretical claims place the emphasis as to how Sukuk could be utilised, particularly with regards to infrastructure; sectorial review indicated a dominance of the financial sector, with limited focus on infrastructural or projects with productivity enhancing character such as manufacturing, communications and industrial utilities.

Sukuk's main stability element is regarded to be in the ownership of the assets; an element regarded crucial in the case of distress; as holders have access to the underlying assets. Reviewing Sukuk defaults in the GCC, proved that the problem was not that investors could not reclaim their assets; but that investor's access to the underlying access was hindered by legal challenges. This was unlike conventional securitization deals, were investors were faced with the problem of multilayer ownership which made access to the underlying asset not feasible. Thus, Sukuk do have a potential to enhance stability if they adhere to the Sharia principles of ownership, risk sharing and transparency; whilst avoid trying to be similar to conventional bonds.

On the other hand, Islamic securitization has potential particularly due to its ethical foundation and its reliance on real tangible assets; two factors, which if implemented conventionally, would have, arguably, reduced some of the unfavourable outcomes of the 2008/2007 crash; as real collateral limits the possibilities of speculative activities.

The review of the underlying collateral indicates the keen focus on the real estate sector, as the former is viewed as a real tangible asset. Though, real estate assets are generally stable, the sector can face challenges and risks which are important to acknowledge. Nevertheless, the main issue impacting the Sukuk stability is the high focus on this sector alone. The strong sectorial focus can be alarming particularly as the real estate market faces difficulties. Thus, there is a need for diversification in the types of underlying assets; in order to enhance the resilience and stability of Sukuk. This can be achieved as issuers originate their own Islamically acceptable assets as opposed to buying asset pools in the market.

Nonetheless, reviewing the different elements of Sukuk, confirms that they are unique financial instruments different to conventional bonds. In addition, Sukuk and Islamic securitization, remain a largely untapped form of structured finance that can and should be regarded as a possible valuable contributor to the stability of the financial environment in GGC and the MENA region. The main stability element is regarded as the ownership claim of tangible assets status; which enables greater control over the active management of designated asset portfolio by investors; as well as the encouragement of genuine transactions through which more business activities could take place as they are based on real, identifiable, existing assets.

Additionally if implemented effectively, the Profit and Loss Share mechanism (PLS) can help provide a balance of wealth in the system, which will protect it from collapsing. Therefore, as financial integration is increasing along with the internationalisation of Islamic finance, growth in the Sukuk market is set to contribute towards a more holistic growth process whilst enhancing financial stability. (Aziz, 2014)

Sukuk have the potential to benefit from the large amount of high-net-worth individuals in many Muslim countries; sceptical about investing there funds in conventional stream. Similarly, they can benefit Ministries of Finance and Central Banks of Muslim countries, through sovereign Sukuk which can be adopted in debt financing policies.

Thus, in order to fully exploit the potential of Sukuk in the GCC, a holistic approach is needed to facilitate the development of domestic markets as well as facilitate access and operations in the international markets. The development of domestic markets can be achieved through ensuring the well-functioning of the money markets; and developing a market infrastructure that facilitates trading, price transparency, as well as efficient clearing and settlement of transactions. The GCC Sukuk market could also benefit from developing a reliable reference curve which helps establish a uniform benchmark for the particularly large. Additionally, the diversification of both underlying assets and investor base will prove to be beneficial. (Kusuma & Silva, 2014).

Yet, reforms are strongly needed in the GCC's legal framework. This strongly manifested in the Sukuk defaults, which exposed the vulnerability of investors to cross-country differences in legal frameworks; as investors' rights were better protected in countries with stronger insolvency regimes. Therefore, the rising volume of cross-border Islamic financial transactions implies the urgent need to harmonize regulatory and legal frameworks; standardizing contracts, strengthening securitization laws, as well as strengthening domestic bankruptcy regimes.

Sukuk structuring also needs to be reviewed; as Sukuk structures can be very complex making it difficult for investors to discern risks. The standardization of contracts as well as strengthening the Sharia approval processes would enhance consumer protection and reduce the confusion with regards to the different mechanisms. The various structures have led to complexities and differences in understanding the documentations, guidelines and best business practices. Therefore, transparency between the issuers, investors, traders, lawyers, and regulators; will help protect both consumers and investors. (Rasameel, 2013; Kusuma & Silva, 2014). Additionally, further professionalism and homogeneity of Sharia Boards would boost the recognition of Islamic Finance in global capital markets and unlock the growing pool of capital in Islamic countries. (Winjnber & Zaheer., 2013)

Finally, it's important to note that in order to achieve the maximum potential and benefits from Islamic financial instruments; the former need to adhere to Sahria principles and avoid trying to be comparable to conventional bonds. The focus on Islamic Financial principles of ownership, risk sharing, transparency and ethical financing; will enable Sukuk to operate effectively, achieve their potential as well as enhance their stabilising impact.

V. ***References:***

Ahamad. N. et al, 2012. *Economic Forces and the Sukuk Market.* Procedia - Social and Behavioral Sciences 65 (2012) 127 – 133

Allen, W.A. and Wood, G. (2006). ‘Defining and achieving financial stability’. *Journal of Financial Stability*, 2 (2006) 152–172.

Ali, A. 2012. Islamic Banking Structures: Implications for risk and financial stability. *Islamic Economic Studies Vol*. 20, No.2, December 2012

Ali.S., 2013. State of Liquidity Management in Islamic Financial Institutions. *Islamic Economics Studies.* Vol. 21, No 1 June 2013 (63-98) Available at : < http://www.irti.org/English/Research/Documents/IES/026.pdf> [Accessed 14 May 2015].

Alam et al, 2013. *Are Islamic Bonds Different from conventional bonds? International evidence from capital market tests. Borsa Istanbul Review 13 (2013) 22-29.*

Alawi.A & Al Quati.S., 2014. *Sukuk: The Sharia Fixed Income Alternative Strategy. September 2014.* Available at: < http://www.aljaziracapital.com.sa/report_file/ess/SPE-171.pdf>

Askari. H., Iqbal.H., Krichene. N. & Mirakhor.A., ,2010. *The Stability of Islamic Finance: Creating a Resilient Finnacial Environmnet for a Secure Future.* John Wiley & Sons (Asia) Pte. Ltd: Singapore.

Archer. S., Ahmed.R.& Karim.A, 2014. IILM Short-Term Sukūk for Liquidity Management: A Success Story in Enhancing Financial Stability. *SEACEN Financial Stability Journal.* Available at: < http://www.seacen.org/products/702001-100356-PDF.pdf>

Askari, H. (2012). ‘Islamic Finance, Risk-Sharing, and International Financial Stability’. Yale Journal of International Affairs, March 2012, pp. 1-8.

Azid, T & Chaudhry.M., 2014. Islamic Financial Instruments and their Impact on Islamic Economies: A Lesson from International Financial Crises. Pakistan Journal of Social Sciences (PJSS) Vol. 34, No. 1 (2014), pp. 333-350

Aziz. Z. 2014. 10th World Islamic Economic Forum (WIEF) - “Sukuk Development and Financial Stability” Dubai, 28 October 2014 Speech by Tan Sri Dato’ Sri Dr. Zeti Akhtar Aziz Governor, Bank Negara Malaysia. [pdf] Available at: < http://www.bnm.gov.my/files/publication/qb/2014/Q4/p6.pdf> [Accessed 29 June 2015].

Babu.D,20014. Emirates NBD Capital eyes top positions on league tables. Available at: < http://m.gulfnews.com/business/emirates-nbd-capital-eyes-top-positions-on-league-tables-1.1420056>

Belouafi. A., 2014. Islamic Finance and Financial Stability: A Review of the theoretical literature. Available at: < http://iei.kau.edu.sa/Files/121/Files/130822_working-paper-3.pdf> [Accessed 25 May 2015].

Bloomberg database, 2015. GCC Islamic bonds Data . Acessed via Kingston University Database.

Bouchard, Thomas J., Jr. 1976 "Unobtrusive measures: An inventory of uses." Sociological Methods and Research, 4: 267-300.

Bourkhis.K & Nabi.M, 2013.Islamic and conventional banks soundness during the 2007-2008 crisis. *Review of Financial Economics* 22 (2013) 68–77

Boukhari.L & Walid. A., 2013. *Risk management of Sukuk Islamic Bonds.* Annual meeting for Islamic engineering . 8/9 December 2013. Available at: < http://iefpedia.com/arab/wp-content/uploads/2013/12/Risk-management-of-Sukuk-Islamic-bonds.pdf>

Bryman.A.,2012. *Social Research methods*. 4th Edition. Oxford: Oxford University press.

Cakir, S. & Raei, F. (2007). Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk? International Monetary Fund Working Paper WP/07/2374

CGFS,2007. CGFS Papers No 28: *Finnacial Stability and Local currency bond markets.* Available at : < http://www.bis.org/publ/cgfs28.pdf > [Accessed 18 June 2015].

Cihak.M & Hesse.H, 2008. *Islamic banks and Financial Stability: An Empirical Analysis.* An IMF Paper. Available at: < https://www.imf.org/external/pubs/ft/wp/2008/wp0816.pdf >

Dow. S et al, 2015. *A critique of Full reserve banking.* [pdf] Available at: < https://www.sheffield.ac.uk/polopoly_fs/1.448817!/file/paper_2015008.pdf >

Elhers.t., 2014. *Understanding the challenges for* infrastructure finance. BIS Working Paper No 454. Avaible at: <http://www.bis.org/publ/work454.pdf>

El Gamal.M., 2006. *Overview of Islamic Finance: Office of International Affairs Paper No 4 August 2006*. Available at: < http://www.nzibo.com/IB2/Overview.pdf>

EY, 2015 . Global demand for Sukuk to reach US$900bn by 2017. Available at: < http://www.ey.com/NN/en/Home/PR_EY--Global-demand-for-Sukuk-to-reach-US-900bn-by-2017>

Campbell.D., and Fiske.D, 1959. "Convergent and discriminant validation by the multitraitmultimethod matrix." Psychological Bulletin, 56: 81-105.

GCC, 2014. *Countries Names*. Available at : <http://www.gcc-sg.org/eng/indexc64c.html?action=GCC >

Gifferty. M., 2014*. Gulf banker Arab Banker: GCC Debt Capital Markets: issuance volumes surge as markets deepen*. Available at : < http://www.gulfbondsukuk.com/doc/Arab%20Banker%20-%20GBSA%20GCC%20Debt%20Markets%20Fall%202014.pdf> [Accessed 29 June 2015].

Godlewski.C et al, 2013. Sukuk vs. conventional bonds: A stock market perspective. *Journal of Comparative Economics* 41 (2013) 745–761

Godlewski.C. Turk-Ariss.R & Weil.L., 2011. *Do markets perceive Sukuk and conventional bonds as different financial instruments? . Bank of Finland Discussion papers 6-2011*. Available at: < http://www.suomenpankki.fi/bofit_en/tutkimus/tutkimusjulkaisut/dp/Documents/DP0611.pdf?&session-id=25c19e7f8355daf897e7dbb4d3239be6 >

Goud.B.,2010. Sukuk have lost a lot of credibility of late. Is this justified? Did we get it wrong? How do we fix it? What are the alternatives to Sukuk?. So Far Journal, 1(1), 7-9.

Helbing.T., 2003. *Housing price bubbles - a tale based on housing price booms and busts*. BIS paper No 21. Available at: < http://www.bis.org/publ/bppdf/bispap21d.pdf>

Hijazi. F., 2009. *Moody's Investors services: Global Sukuk Issuance: 2008 Slowdown Mainly Due to Credit Crisis, But Some Impact from Shari'ah Compliance Issues*. Special Report 21 January 2009. Available at: < http://www.kantakji.com/media/7753/f156.pdf >

HM Treasry, 2012. *A new approach to public private partnerships.* Available at: <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205112/pf2_infrastructure_new_approach_to_public_private_parnerships_051212.pdf >

IIFM, 2015. Sukuk Report A Comprehension study of the Global Sukuk Market November 2014 : 4th Edition.

IFSB, 2009. *CAPITAL ADEQUACY REQUIREMENTS FOR SUKŪK, SECURITISATIONS AND REAL ESTATE INVESTMENT*. January 2009. Available at: < http://ifsb.org/standard/ifsb7.pdf>

IFSB, 2010. Islamic Finance and Global Financial Stability: April 2010.

IMF, 2015. IMF Public Data. United Kingdom: Economic indicators Available at: <http://elibrary-data.imf.org/DataReport.aspx?c=1449311&d=33120&e=170185 >.[Accessed 1 September 2015].

Jick.,T. 1979. Mixing Qualitative and Quantitative Methods: Triangulation in Action. Available at: < http://faculty.washington.edu/swhiting/pols502/Jick.pdf>

Jeaneau.S & Tovar. C., 2007*. Financial stability implications of local currency bond markets : an overview of the risks.* BIS paper *no 36 Available at: < http://www.bis.org/publ/bppdf/bispap36e.pdf >*

Jobst.A., 2007. *The Economics of Islamic Finance and Securitization.* IMF working paper. Available at: < http://www.imf.org/external/pubs/ft/wp/2007/wp07117.pdf >

Jobst et al, 2008. *Islamic Bond Issuance—What Sovereign Debt Managers Need to Know*: IMF Policy discussion paper. Available at: < https://www.imf.org/external/pubs/ft/pdp/2008/pdp03.pdf>

Jobst.A.,2010. *Islamic Securitization after the credit crisis*. Available at: < http://new.mbri.ac.ir/userfiles/file/Islamic%20Banking/%D8%A8%D8%A7%D9%86%DA%A9%20%D9%85%D9%82%D8%A7%D9%84%D8%A7%D8%AA/sukuk/Islamic%20Securitization%20After%20the%20Credit%20Crisis.PDF

Kammer. A., et al, 2015. *IMF Discussion Note: Islamic Finance: Opportunities, Challenges, and Policy Options: April 2015.* Available at:< http://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf> [Accessed 16 June 2015].

Karawowski.E.,2009. *Financial Stability: The Significance and Distinctiveness of Islamic Banking in Malaysia*. The Levy Economic institute: Januaty 2009.

Kern.S., 2014. GCC financial markets Long-term prospects for finance in the Gulf region: Deutsche Bank Research. Available at: < https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000296909/GCC+financial+markets%3A+Long-term+prospects+for+finance+in+the+Gulf+region.pdf>

Kindelberger. C. & Aliber.R., 2005 . *Manias, Panics, and Crashes: A History of Financial Crises.*5th edition. New Jersey: John Wiley & Sons, Inc.

Khan. F., 2010 . *How Islamic Is Islamic Banking?* Journal of Economic Behavior & Organization 76 (2010) 805–820

Kususma. K & Silva.D. 2014. *Sukuk Markets: A Proposed Approach for Development.* IMF Working Paper . Available at: < http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/12/04/000158349_20141204142423/Rendered/PDF/WPS7133.pdf>

Lackmann .B., 2015. Types of Islamic Bonds (Sukuk) and History of Japanese Company Issuance. *Nomura Journal of Capital Markets Winter 2015 Vol.6.No.3.* Available at: <http://www.nicmr.com/nicmr/english./report/repo/2015/2015win02.pdf>

Lukonga. I, 2015. Islamic Finance, Consumer Protection and Financial Stability. IMF Working paper. Available; at: < http://www.imf.org/external/pubs/ft/wp/2015/wp15107.pdf>

Lupica.L, 1998. *Asset securitization: The Unsecured Creditor's prospective*. The Texas Law review. Vol 76 p 595

Markaz, 2015. *GCC Market Outlook 2015*. Available via Markaz Kuwait Financial centre database.

Mayers.T. & Hassanzadeh.E., 2013. (IISD: International Institute for Sustainable Development). *The Interconnections between Islamic Finance and Sustainable Finance.* Available at <> [Accessed 14 May 2015]

Mersch.Y, 2009. Yves Mersch: *About the role of central banks in financial stability and prudential liquidity supervision, and the attractiveness of Islamic Finance*. Available at: < http://www.bis.org/review/r090518c.pdf >

MIFC, 2015. *Annual Sukuk Report 1Q 2015.* (15 May 2015) Available at : < http://www.mifc.com/index.php?ch=28&pg=72&ac=124&bb=uploadpdf> [Accessed 09 June 2015].

Minsky. H., 1992. *The Financial Instability Hypothesis,* available at: < http://www.levyinstitute.org/pubs/wp74.pdf> [pdf] [Accessed 10 March 2015].

Mishkin. F, 1999. Global Financial Instability: Framework, Events, Issues .The Journal of Economic Perspectives. Vol. 13, No. 4 (Autumn, 1999), pp. 3-20

Mishkin, F., (2000), “Financial Stability and the Macroeconomy”, Central Bank of Iceland Working Paper No. 9, May

Mohd Noor & Shahimi, 2013. Credit Risk Management for Sukuk: A Case Study of Debt-Based Sukuk. Available at: < http://www.ukm.my/fep/perkem/pdf/perkemVIII/PKEM2013_5A1.pdf>

Mohammed.N., 2014. *How Sukuk and Bond defaults differ – The role of the Trustee and the Purchase undertaking agreement.* Available at: < http://www.sukuk.com/education/sukuk-bond-defaults-differ-role-trustee-purchase-undertaking-agreement-1522/ >

Mohammed.N., 2014. *Five Important Differences Between Sukuk and Traditional Bonds.* Available at: < http://www.sukuk.com/education/important-differences-sukuk-traditional-bonds-2207/>

Moore. B., 1988. The Endogenous money supply. *Journal of Post Keynesian Economics.* 1988 Vol 5 No3.

Pwc, 2014. *Islamic Finance: Creating value. [pdf]* Available at : < https://www.pwc.com/m1/en/publications/islamic_finance_capability_statement.pdf> [accessed 09 June 2015].

Raja Abd Aziz, R.T.M . (2010). *Sukuk have lost a lot of credibility of late. Is this justified? Did we get it wrong? How do we fix it? What are the alternatives to Sukuk?.* So Far Journal, 1(1), 7-9. Available at: < http://mec.biz/term/uploads/YASARMED-30-03-2010.pdf>

Rasameel RSF, 2014. Quarterly Global Sukuk Report: April 2014 . [pdf] Available at: < http://www.rasameel.com/downloads/RSFGlobalSukukMarketQ12014.pdf>

Rasameel investmenst Bank Dubai RSF, 2014.Global Sukuk Market: Quarterly Bulletin July 2014 Available at: < http://www.rasameel.com/downloads/RSFGlobalSukukReport1H2014-sep11.pdf>

Reuters, 2014. MIDEAST DEBT-Gulf banks start to muscle in on global bond deals. Available at: < http://www.reuters.com/article/2014/07/03/mideast-banks-bonds-idUSL4N0PA0A420140703>

Rocha.R, Arvai.Z & Farazi,S 2011. Financial Access and Stability A Road Map for the Middle East and North Africa. The World Bank. Available at : < http://siteresources.worldbank.org/INTMENA/Resources/Financial_Flagship_Report_Middle_East_North_Africa_2011_Full_Report.pdf>

Salah.O., 2010. *Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk.* Available at: < http://bjil.typepad.com/Dubai%20Debt%20Crisis.pdf>

SHC, 2013. Saudi Hollandi Capital: Sukuk Market in Saudi Arabia: Mat 2013. Available at: < http://shc.com.sa/en/PDF/RESEARCH/Sukuk%20Market%20in%20Saudi%20Arabia.pdf>

Shin.H., 2009.Securitization and Financial stability. *The Economic Journal March 2009.* Available at: < http://www.princeton.edu/~hsshin/www/securitisation.pdf> .

Solovieva.B., 2015. *Get Ready for Corporate Sukuk Boom after sovereign Rush*. Avaible at: < http://www.bloomberg.com/news/articles/2015-01-05/get-ready-for-company-boom-after-sovereign-rush-islamic-finance>

S&P, 2012. Standard & Poor experience: Infrastructure Sukuk: Special Report. Available at: < http://www.standardandpoors.com/spf/upload/Ratings_EMEA/Slide_Deck_Dubai_IF_Conference.pdf?elq=44373115fa0248cc8c81d6760c72dbef>

S&P, 2012. *Standard & Poor's Ratings Definitions.* Available at : < http://www.standardandpoors.com/spf/general/RatingsDirect_Commentary_979212_06_22_2012_12_42_54.pdf >

Sundararajan.V & Errico.L., 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key issues in Risk management. IMF paper.* Available at:< http://www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf > [Accessed 01 July 2015].

Tariq. A & Dar.H., 2007. *Risks of Sukuk Structures: Implications for Resource Mobilization.* Wiley Inter science Publications. Available at : < http://www.kantakji.com/media/7986/m139.pdf> [accessed 30 June 2015].

Thomas.A, Cox. S & Karty. B., 2005. *Structuring Islamic Finance Transactions.* London: Euromoney Books.

Visser.H., 2013. *Islamic Finance: Principles and Practice .2nd Ed.* Edward Elgar Publications: Cheltenham.

Winjnber.S & Zaheer.S., 2013. *Sukuk* Defaults: on Distress Resolution in Islamic Finance. July 2013. Availabel at: < http://papers.tinbergen.nl/13087.pdf >

Wilson.R. 2008. Innovation in the structuring of Islamic Sukuk securities'. *Humanomics Journal*. Vol. 24 No. 3, 2008

World Bank, 2015. *Data: GDP (current US$).* Available at: < http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?page=2>

WRC, 2013.. *Sukuk: from a niche instrument to a global financial alternative. World Commerce Review: June 2013 86-87*.[pdf] Available at: <http://www.worldcommercereview.com/publications/article_pdf/731> [Accessed 09 June 2015].

Zaheer .S and Van Wijnbergen.S. 2013. *Sukuk Defaults. Zawaya: Thomas Reuters*. Available at: < https://www.zawya.com/story/Sukuk_defaults-ZAWYA20131223084538/>

Zakaria.N et al, 2012. The Construct of Sukuk, Rating and Default Risk. *Social and Behavioral Sciences* 65 (2012) 662 – 667

Zerban. A., ElKady.E & Omar.R., 2012. Islamic finance and Global Financial Crises: How to keep Finance of Track? *Topics in Middle Eastern and African Economies*. Vol. 14, September 2012. [pdf] Available at:<http://www.luc.edu/orgs/meea/volume14/PDFS/Islamic%20Finance%20and%20Global%20Financial%20Crises-How%20to%20Keep%20Finance%20on%20Track.pdf> [Accessed 14 May 2015]

Zhu. H., 2003. *The importance of property markets for monetary policy and financial stability*. IBS paper N21. Available at: < http://www.bis.org/publ/bppdf/bispap21c.pdf >

Appendix:

Table 1 Main Sukuk types (Lackman, 2015; Kammer et al, 2015)

Sukuk type	Characteristics
Murabaha (mark-up sale)	Usually used for purchasing products under an instalment sales contract. In this type of transaction, an asset is acquired by the purchaser (usually a bank); from a third party, at the demand of the originator. The product is then resold to the originator at an agreed mark-up for immediate or deferred payment in instalments.
Isstisna (Supply agreement)	Generally used in infrastructure and large developmental projects. In this type, the Islamic financial institution funds the project during its construction phase, whilst acquiring the title to that asset. Ownership is then passed on to the developer upon competition of the project.
Salam (futures contract)	The buyer pays the seller the full price of a product, with the promise to be delivered at a future date.
Ijarah (rental and lease agreements)	Based on a leasing scheme, the financing party purchases property, equipment or other asset desired by the originator and then leases it to the client for a rental fee. At maturity the originator repurchases the underlying asset.
Wakala (agency agreement)	One party (either the bank or client) serves as an agent to the originator undertaking transactions on his behalf.
Mudaraba (partnership agreement)	A partnership agreement where the funds to finance a project are supplied by the provider of capital; while the entrepreneur offers labour and expertise. Profits ratios are agreed upon and are shared accordingly. However, in the case on loss, all losses are borne by the owner of capital; as the liability of the entrepreneur is restricted only to his time and effort.
Musharakah (Equity partnership agreement)	Represents ownership of partnership equity. The financing party and originator contribute assets (cash or property) to a joint venture and share the generated profits according to predetermined ratios, whereas losses are split according to the respective capital contributions.