Prospect of Sukuk in the Fixed Income Market: A Case Study on Kuwait Financial Market

Saadi Al Trad, Ph.D.[1] & Rafiq Bhuyan, Ph.D.[2]

[1] Investment Manager, Kuwait Investment Authority, Ministries Complex, P.O. Box 13001, Kuwait

[2] Department of Finance, College of Business and Economics, American University of Kuwait, P.O. Box 3323, Safat 13034, Kuwait

Correspondence: Rafiq Bhuyan, Ph.D., Professor, Department of Finance, College of Business and Economics, American University of Kuwait, P.O. Box 3323, Safat 13034, Kuwait. Tel: 965-2224-8399-3541.

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Abstract

Regional Islamic capital market for fixed income securities has been growing steadily and noticeably as Sukuk has been emerging as an alternative and important instrument to conventional debt instrument in the fixed income market. Although the country has largest muslim population, Kuwait's fixed income capital market is still dominated by conventional debt instruments. Further, the central bank of Kuwait has been the major issuer of the conventional bond and not an issuer of Sukuk. The small number of sukuk issues in Kuwait compared to bonds is due to lack of clear law and regulation, shortage of expertise in structuring sukuk, and absence of government issued sukuk. Among the sukuk issued in Kuwait, only one sukuk has defaulted and has gone through restructuring during the period of global financial crisis when many financial institutions have failed around the world. This should be taken positively as a prospect of sukuk as an alternative to bond as viable fixed income security. We believe that the role of central bank is key to the prospect of flourishing Islamic financial instruments such as sukuk in Kuwait as well as in the global fixed income markets.

Keywords: Sukuk, fixed income, Sharia, Islamic financial instrument

1. Introduction

Demand for Islamic financial instruments has been on the rise around the world. Since the global financial collapse of 2008, Islamic financial instruments have been regarded as an attractive alternative to traditional financial instruments. Islamic instruments are designed in full compliance with Islamic Shariah rules that considers factors such as prohibition of interest (riba), risk sharing, prohibition of speculative behavior, security of contracts and preservation of property rights. Even under these constraints, Islamic financial instruments offer very competitive return compared to traditional instruments and that has received attention not only from investors with Islamic faith but also from investors with other religion. Traditionally, bond instrument, both government and corporate, has been one of the main sources of funding in the capital market and fixed income security for investors. Bond is a cheaper source of capital compared to common and preferred stocks that corporation can consider issuing in the capital market. Sukuk is an alternative Islamic financial instrument, issued by corporations or government, which matches the structure of a traditional bond instrument except that instead of paying interest it pays a fixed portion of profit and loss. In this paper we focus on the prospect of Sukuk in Kuwait as an attractive and alternative to bonds in Kuwait fixed income market. The fixed income market in Kuwait is still dominated by conventional bonds issuances and the sukuk is still at its infant stage as the market itself is not fully developed. The Central Bank of Kuwait (CBK) is the key issuer of conventional bonds among other corporations in Kuwait. Most corporations also issue the conventional bonds for their capital financing and very handful of corporations issue sukuk in Kuwait. This observation makes it interesting to conduct research on the prospect of sukuk instruments for Kuwait where more than 90% of the population is Muslim. In order to serve the muslim community, the Kuwait capital market needs to develop its fixed income market, especially, Sukuk instruments as it is very limited compared to traditional bonds instruments.

The main objective of this paper is to analyze the following questions:

1. What is the status of Sukuk in the Kuwait market relative to conventional bonds?

2. Has Sukuk as an Islamic financial instrument proved attractive to investors based on previous issues, and if so what are the reasons for this?
3. Has there been any Sukuk defaults in Kuwait, and if so what impacts, if any, have these had on the capital market?
4. What expectations should market participants have?

In this research, we use bond and sukuk data issued in Kuwait from May 2005 until May 2014 to address our research questions. The rest of the paper is organized as follows. In section 2, we review the literature on Sukuk. Section 3 examines the definition and characteritics of sukuk. Section 4 covers the structure of *ijarah* and *musharakah* Sukuk. Section 5 examines Sukuk structure, while section 6 reviews data on the Sukuk market in Kuwait followed by the conclusion in the next section.

2. Literature Review

The literature on Sukuk has developed significantly over the past decades, owing to an increase in the appetite for investment in Islamic finance instruments and to the demand for shariah-compliant investments. This literature is still not as large as that of conventional bonds, however, and there is still a wide gap, which needs to be filled. Wilson (2006) examines the use of Sukuk as a tool for liquidity management, and includes analysis of *murabaha*- and *ijarah*-based Sukuk, since they provide a fixed return and are the most popular forms of Sukuk. In addition, *musharakah* Sukuk are mentioned as another tool that can be attractive in terms of portfolio diversification. Wilson finds that there is risk associated with using sukuk as a tool for liquidity management; such risk includes default risk, and corporates involved in real estate those Sukuk could face price decline. In addition, based on Sukuk and Islamic structure derived from the principle of risk sharing, financial return may be variable rather than fixed. At the same time, Jobst *et al.* (2007) discuss how Islamic lending is governed by the principle of shariah, which prohibited interest (*riba*), whereas investors should receive income in the form of a return on investment. Jobst *et al.* point out that there are two phases in the issuance of Islamic sukuk. These relate to: (1) what security is traded (its type and the nature of the business); and (2) how the deal is structured because of Islamic financial principles. However, they found that if the capital market were inefficient the Islamic banks' legal framework would create pressure to decrease the growth of the Sukuk market. In addition, the Islamic instrument would have been placed on a solid infrastructure over and above the Islamic principles. Jobst *et al.* (2007) review the development of the sukuk and capital markets, examining the challenges and opportunities as the Sukuk market continued to grow during the period they studied. They point out that the Sukuk market continued to grow particularly since sovereign and government entities increased their appetite to diversify their fundraising instruments in order to attract more investors for both Muslim and non-Muslim bodies. This growth, they conclude, is expected to continue, based on the increased interest in investing in Islamic instruments, especially in the case of sovereign Sukuk, which evidenced greater popularity. At the same time, they find that some constraints arise owing to legal concerns, including legal uncertainty connected with the regulatory mechanism. Al-Amine (2008) discusses innovation in and challenges to the Sukuk market, and explores how Sukuk instruments give great scope for innovation and potential for the growth of Islamic finance. He shows how the introduction of the issuance of different Sukuk, such as *ijarah*, *musharakah*, *ijarah* with *istisna*, and *murabaha*, has created different shariah, legal and economic issues and controversies. These challenges are discussed, especially those relating to capital guarantee, contractual structure, pricing, and assets substitution in the case of *ijarah* and *musharakah* Sukuk. Even though there is huge growth in investment in Islamic Sukuk and huge demand for this, there are some issues relating to these instruments that need to be resolved. Al-Amine concludes that there needs to be more co-operation among financial experts, shariah scholars and the shariah board. In addition, Islamic instruments do not need to be accepted only because of shariah principles, but they should be accepted from a shariah-compliant perspective first and foremost; this will enhance the Islamic economy in real terms. Vishwanath and Azmi, in their 2009 article giving an overview of the Islamic Sukuk, found that Sukuk can be used as a tool for liquidity management in order to mobilize cash in the market. They also point out that the advantage of Sukuk lies in the safety of the instruments. The interest generated by the issuer or the lead manager provides investors with the option of choosing either a fixed or a variable return based on the future market expectation of the Sakk and the equitable distribution of the return for the investors, since the Sukuk is distributed in equal shares among the Sukuk holders. Zin *et al.* (2011) explore the practice of and the prospects for the Sukuk market in Malaysia based on the recent growth of this market. They examine the differences between the Sukuk and the bond markets, concluding that Sukuk are instruments, which attract investors through a mixture of low risk and shariah-compliant principles. In addition, they found that Sukuk and Islamic instruments could be used to encourage financial flows across borders, and help to achieve growth and long-lasting economic developments. They also found that Sukuk has in the past been proven as an important instrument for strengthening financial co-operation. Muhamad and Radzi (2011) discuss the importance of Sukuk structure and how it can influence investors, especially when there is a default. They focus on Sukuk *ijarah*, and discuss the implications of the Sukuk structure using an asset-based or an asset-backed structure. They review previous discussions and blame the Islamic structure based on Shariah compliance as the source of real-estate manipulation cosidering the Dubai defaults experience. They conclude that Sukuk structure should be selected because of asset-based and asset-backed Sukuk, and that the defaults on asset-based Sukuk can be recognized as defaults on a bond that is not secured. There is no guarantee on any issued Sukuk because of its structure. Furthermore, the asset-backed Sukuk is the more secured of the two.

3. Definition of Sukuk & Sukuk Characteristics

Sukuk is an Islamic fixed instrument that is used for raising capital by institutions, and is equivilant to conventional bonds. However, Sukuk has its own unique characteristics and features, which are different from those of conventional bonds. The word 'Sukuk' is derived from the Arabic word *sakk*, which is a singular; *sukuk* is the plural. The term 'Sukuk' in Islamic finance is used when referring to an instrument that is used to raise funds. The issuing and the use of Sukuk has in principle to comply with the Shariah if investors are to be allowed to accept investing in or using Sukuk. Hafizuddin *et al*. (2010) define Sukuk as one of the Islamic financial instruments that can be used to raise funds, seeing it as a vital instrument for managing resources and cash, one which can be used by both the public and the private sectors. The Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) has recently defined Sukuk in terms of certificates of ownership of a share of a specific tangible asset, which can be extended to partial ownership of a project or investment. The importance of Sukuk, and the increased demand by investors interested in investing in it, has increased the debate surrounding Sukuk: Are Sukuk different from conventional bonds, or are they just another, Islamic version of conventional bonds? It is undeniable that over the past few decades, the worldwide use of Sukuk by both Muslim and non-Muslim participants has increased, owing to their innate characteristics and their risk- and profit-sharing profile. Sukuk is different from conventional bonds in terms of their structure. Even if there are some similarities, still one cannot say that Sukuk is similar to conventional bonds. In the first place, Sukuk cannot be issued if they do not comply with the shariah, where as a bond is considered from a financing point of view by its issuer. In Islamic Shariah, investing in conventional bonds is prohibited by the principles of Islam, which do not allow the use of cash for cash. Sukuk is structured and designed in such a way that they do not allow investors to receive interest on their investment. However, actual investment in Sukuk reflects the privileges of the Sukuk holder in sharing the risk, and profits based on the certificate of ownership. By investing in Sukuk, the investor certainly has to accept and share the risk return on the investment, whereas the bond is a debt obligation and the issuer is obliged by contract to pay an interest payment based on the agreed terms, and the principal upon maturity. However, Sukuk is an asset-backed security certificate, which provides the Sakk holder ownership of such an asset or asset-backed security. Investing in Sukuk gives the investor the right to receive a return based on ownership of the Sakk. The next section offers review of some Sukuk structures, especially those that are commonly issued including *ijarah* (as it seems the most popular), *musharakah* and *convertible* Sukuk.

4. Sukuk Structure

Even though there exists no 'official' Sukuk structure, AAOIFI has produced a set of guidelines as to how Sukuk is structured. Companies and institutions interested in financing, investing in or purchasing an asset using a Sukuk instrument should follow these steps:

1.1 The originator or issuer has to develop an SPV (special purpose vehicle), which should purchase one or more assets.

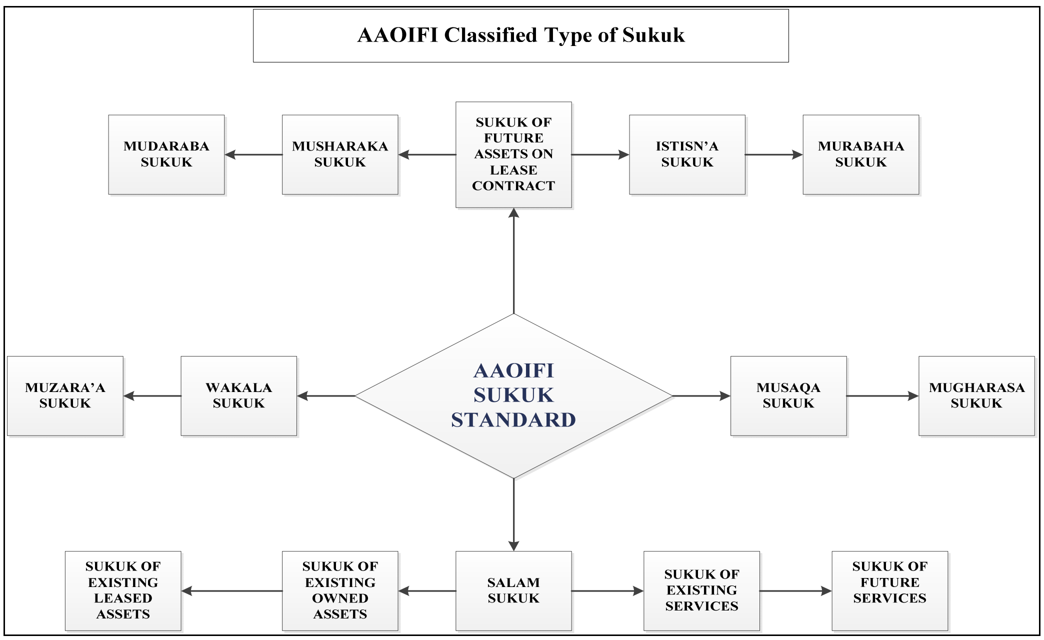
1.2 Sukuk notes or certificates are issued to finance the acquisitions by receiving cash from the Sukuk participants or investors.

1.3 After that, SPV should sell or lease back the assets to the originator or the issuer, or any third entity connected with the originator.

1.4 A service agreement should be issued to the lessee to carry out duties on behalf of the lessor.

1.5 The return on the Sukuk or the lease payment should be received by the Sukuk certificate holders in the same way as the coupon in conventional bonds.

As mentioned above, and by definition of Sukuk, there is an ownership of a proportion of an asset. From a Shariah point of view, SPV owns the assets before transferring the right to lease it; therefore, ownership of the assets is essential from a shariah perspective. However, until recently, the majority of these Sukuk instruments had not been used or issued by Sukuk issuers. The most commonly used Sukuk are *ijarah*, *mudarabah*, *musharakah*, *salam* and *istisna*. Different types of Sukuk are used for different purposes. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has identified 14 types of Sukuk as shown in Figure 1. Wilson (2008), in his discussion paper, provides an analysis of the different types of Sukuk structure, finding that the SPV is a pre-requisite for the successful management of the Sukuk. He also states that Sukuk can only be acceptable from a Shariah perspective if it is backed with a real asset, to allow the purchaser and seller to deal with a real tangible asset and not papers. Yaakub *et al.* (2011) analyze both asset ownership and investing Sukuk holders' right and protections. Yaakub *et al.* (2011) examine the continuing growth of the Sukuk industry and how the markets regard Sukuk as an alternative tool to conventional bonds. They conclude that the issue of asset-backed vis-à-vis asset-based Sukuk needs to be clearly defined, and that asset-backed Sukuk *ijarah* provide more protection to investors than asset-based Sukuk *ijarah*. In addition, they find that prior to shifting from asset-backed to asset-based Sukuk *ijarah*, the ruling of a standardized shariah *fatwa* has to be created, in order to minimize the differences among shariah scholars in the different jurisdictions.



Source: Nathif (2006).

Figure 1

The structure of the Sukuk is issued in different ways, because of the securities traded. Sukukholders have partial ownership of the traded securities, which is different from the typical conventional bondholders. There are two types of Sukuk discussed below that are widely used by corporations for financing puposes: Sukuk *ijarah* and Sukuk *musharakah*.

4.1 Sukuk Al-Ijarah

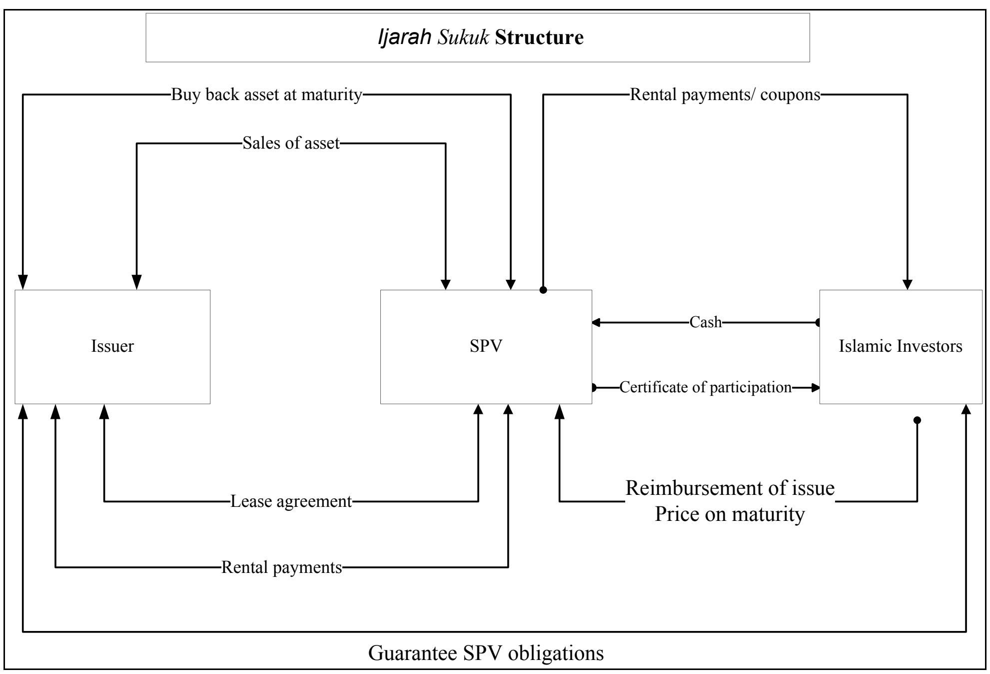
Usmani (2006) defines *ijarah* as being 'to give something on rent'. Usmani highlights two different situations in which the term '*ijarah*' is used, based on Islamic jurisprudence: (1) 'to employ [the] services of a person on wages given to her/him as a consideration for her/his hired services' (in this case, we call the employer '*musta'jir*' and the employee '*ajir*'); and (2) '*Ijarah* relate to the usufructs and properties, and not to the services of human beings'. Usmani defines type (1) as follows: '*to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him*'; whereas the second type is equivalent to the conventional term 'leasing'. The parties involved in this particular transaction are called *mu'jir*, which in conventional terms is the lessor; *musta'jir* is the lessee, and *ujrah* is the rent payable to the *mu'jir* (Usmani 2002). *Ijarah* and sales seen as being to some extent similar, since both require the transformation of something from one entity to another entity for a value. Nevertheless, *ijarah* is different in form usufruct that gives the *mu'ajir* the right of usufructs, where the sale consists of ownership transferred from the seller to the purchaser. Therefore, one can conclude that *ijarah* is not a form of financing. *Ijarah* is an Islamic instrument, which can replace the terms of a conventional lease, but with some restrictions based on Islamic *fiqh*. The use of bonds is prohibited in Islam, and therefore for the introduction of Sukuk *ijarah* is used as an equivalent of conventional bonds.

If one sees that Sukuk *ijarah* in Islamic finance has some similarities to the terms of a conventional lease, a Sukuk issuer applies a mark-up or a margin to prospective traded securities. However, *ijarah* Sukuk has assets with a lease agreement that generates a rental return. In addition, the ownership of Sukuk gives the holder the right to generate income and bear all the costs based on AAOIFI principles. Additionally, the *ijarah* contract lays out the payment terms in advance, or while the rental lease is going on, or at the end of the lease term. Thus, the *ijarah* contract has some flexibility to be used for different purposes according to the issuer's preferences. *Ijarah* is acceptable when the security or asset is appropriate to be leased, such as any tangible assets, land, machines or cars.

Islamic principles prohibit *riba*, that is, 'interest on money and cash for cash lending', and the structure of *ijarah* Sukuk, described below, shows that there are certain criteria that have to be met. Wilson (2006) describes the structure of Sukuk *ijarah*, as follows:

- The assets involved are held by the SPV.
- The issuer sells the assets to the SPV and buys it back at maturity.
- Lease agreements have to be made as a part of the contract.
- Each Sakk holder receives a certificate according to the proportion invested in the Sukuk.
- Rental payment is received by the Sukuk holders.

Ijarah is the equivalent of a lease in Islamic finance. As mentioned above, Islamic principles prohibit *riba*.



Source: Wilson (2006).

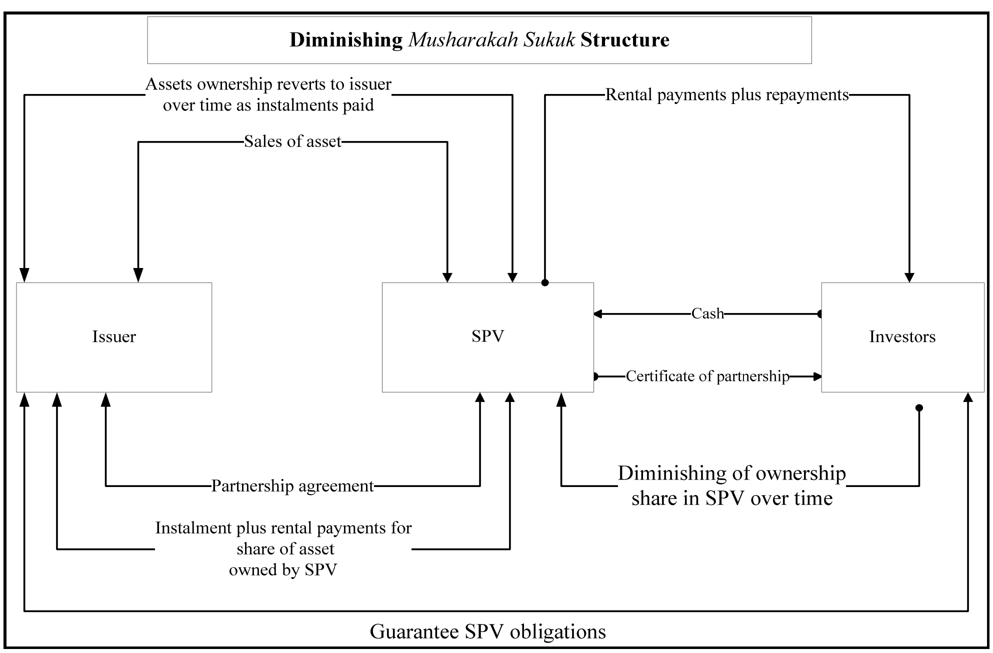
Figure 2

Figure 2 explains the structure of *ijarah* instruments. This type of Sukuk is usually used for long-term securities such as real estate assets, machines and equipment. *Ijarah* allows the financiers or investor to earn income because of its structure. Participating or investing in *ijarah* exposes both parties – the Sukuk holder and the issuer – to a share in the profit and the risk of loss. This is what makes it different from conventional loans or bonds. The evolution of Islamic finance over the past decades has made it very challenging for countries and financial centers to provide the infrastructure for investors interested in Islamic instruments. *Ijarah* Sukuk provide financiers and investors with the privilege of receiving revenues because of agreed leased payments. At the same time, another sort of *ijarah*, called '*ijarah* with *iqtina*', gives the lessor the option to purchase the assets based on agreed terms. Sukuk *ijarah* are the most common instruments used by issuers owing to their flexibility and structure. *Ijarah* Sukuk give Sukuk holders the gain of a periodic return based on the agreed terms during the issue of the Sukuk. The same Sukuk can be used, as mentioned earlier, to buy or lease tangible assets (such as land, property, machines, cars and equipment), which make it flexible to use. In addition, the income is generated from the rental of the assets.

4.2 Sukuk Musharakah

Musharakah, often considered as business partnerships, involves different investors partnering in a specific project. The basic concept of *musharakah* is that investors or business entrepreneurs meet to raise funds for investment purposes, bearing in mind that they all share both the risk and the returns of the project. *Musharakah* is another Sukuk, which is commonly used beside *ijarah*. The AAOIFI defines *musharakah* Sukuk as certificates of equally divided value, which are issued to raise capital by a corporate institution to develop or establish a project or a business. *Musharakah* certificates privilege the Sakk holder of the ownership entitlement in the proposed project or assets based on the issuer. They can be purchased by *mudarab*, or investment agencies. The term '*musharakah*' derives from the Arabic word '*shirkah*', which means sharing, but in Islamic financial terms *musharakah* means a joint enterprise, which gives each *sharik*, or partner, the privilege of sharing profits and losses in a specific project (Usmani 2002). *Musharakah* is one of the Islamic instruments used by fundraisers when they wish to raise funds to finance a project or business on Islamic principles, which do not allow the use of funds for funds. As conventional finance plays an important role in conventional economy, *musharakah*, from a Muslim economic perspective, can fulfil the same role in an Islamic economy. *Musharakah* is participation in the real project, where the profits are shared in pre-agreed amounts and the losses are shared according to the proportions invested by the *sharik*. It is therefore different from a conventional loan, since the Sakk holder takes the risk of losing their funds, whereas in a conventional loan the bank money is guaranteed by some sort of collateral, even though in some cases the collateral can also lose its value or depreciate. Wilson (2006) demonstrates the structure of the *musharakah* Sukuk in Figure 3. This shows that the Islamic bank or Islamic financial institution to manage and administer the Sukuk payments commissions the SPV. The administrative and the legal structure is the same as in *ijarah* Sukuk, but the payments are different. The following steps are required:

1. The SPV has to be established.
2. The Sukuk issuer sells the assets to SPV under a signed partnership agreement.
3. Investors in this kind of Sukuk receive partnership certificates indicating the amounts they have invested.
4. The investors' partnership declines as time goes on towards the end of the term, and payments are made before the issuer buys back the assets.
5. The agreed return and rental payment give the investors their income.



Source: Wilson (2006).

Figure 3

The structure of *musharakah* Sukuk gives the Sukuk issuers some flexibility to decide the payments based on the pre-agreed terms. Based on the above discussion, we can summarize the features of *musharakah* Sukuk as follows:

1. It is profit and loss sharing instrument based on the proportion of the investment divided.
2. Not all partners in *musharakah* have the right to manage the project invested.
3. SPV has to be established for the project to receive investors' fund to finance the investment opportunity.
4. All partners enter into an agreement in Sukuk *musharakah.*
5. Sukuk holders receive only such profit as has been agreed or pre-determined.
6. At maturity, the Sukuk issuer has to buy back the Sukuk fully from the Sukuk holders.

Sukuk, in Islamic economics, may be a substitute for conventional bonds, and have consequently been used for capital financing. As we have seen earlier, there are different types of Sukuk, but here we have considered just *musharakah* and *ijarah*. Each one of these Sukuk is used for a different purpose. *Ijarah* can replace the conventional lease instrument to facilitate real-estate projects, machines and equipment, in the long term. *Musharakah* is used for partnership investment opportunities. It has a marked economic impact, since it provides different Islamic instruments for investors to increase the potential of Sukuk issuers. Said and Grassa (2013) examine the macroeconomic factors that influence the structure of the Sukuk, and find that macroeconomic factors, such as per capita GDP, the economic size of a country and the openness of an economy to trade, all have a great impact on Sukuk structures and issues. They positively influence fundraising, in that they make it easier for issuers to receive funds from external participants. In addition, Said and Grassa find that the recent financial crisis has had a negative impact on the Sukuk market. However, they affirm that the Dubai debt crisis has had no negative effect on the Sukuk market. In addition, Said and Grassa find that the bonds market has had a positive impact on the Sukuk market, and one can say that this is a complementary instrument rather than a substitute. They also suggest that countries with a high quality of regulation support the development of the Sukuk market, especially those that have adopted Islamic shariah law mixed with common law, since shariah provides the principles on which Islamic finance based.

5. Sukuk and Bond Markets in Kuwait

Islamic capital market over the past decades has witnessed growth globally. Kuwait market is not different from those other markets. In April-2005, the Commercial Real Estate Company issued the first Islamic Sukuk of USD 100 million in Kuwait. The Sukuk offering of a fully underwritten $100 million as Islamic *Ijarah* Sukuk (leasing bond). This issue is the first under Islamic Shari'a offered in Kuwait to finance its expansion and growing development projects. The Structure of the *Ijarah* Sukuk as a *lease-to-own* Islamic Shari'a compliant securities with 5 years term maturing in 2010 offering a semi-annual return of 125 basis points over US dollar 6 months LIBOR. The Sukuk *Ijarah* is *lease-to-own* instrument, which allows the CRC issuer the right to re-own the assets after the maturity of the lease term. In addition, the Sukuk is expected to be listed on Bahrain Stock Exchange and the investors who wish to invest in Islamic sukuk should be able to do so as an Islamic instrument. Leading Islamic financial institutions in Kuwait such as Kuwait finance house (KFH), Liquidity management Center (LMC) Bahrain, who arrange and structure advisors for this issue have made great comments on the issues. Deputy General Manager at KFH and Chairperson of Boubian bank believe that more cooperation and collaborations with both local and regional companies is expected to issue more sukuk that can enhance and help the economic development.

5.1 Sukuk and Conventional Bonds in Kuwait

Since the mid-2005 until May of 2014 the Kuwait debt market has a total of USD 3.00 billion Sukuk issuance. The main issuers of these sukuk are companies and not the central bank of Kuwait. Table 1 and 2 below show that total corporate sukuk are 18 issues totaling USD 2,486.98 million averaging USD 138.16 million per issue, versus 4 quasi-sovereign issues in the amount of USD 513.61 million with an average size of USD 128.402 million. As we can see, the corporate and quasi-sovereign institutions are the main issuers of sukuk in Kuwait.

Table 1. Sukuk issues

Sukuk Analysis		
Issuers	Number of issues	Issue Size (USD million)
Corporate	18	2,486.98
Quasi Sovereign	4	513.61
Total	**22**	**3,000.59**

Sources: Zawya Islamic data from May -05 to May-2014

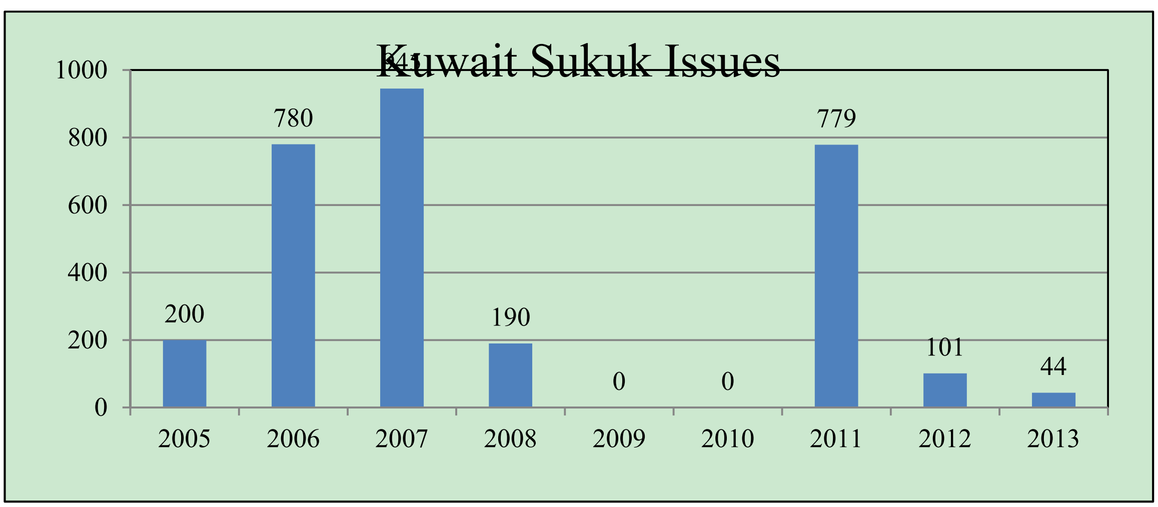
The corporate Sukuk represents about 82% of the total amount for sukuk issued in Kuwait while the quasi-sovereign sukuk represents 17% of the total amount of sukuk issues. Kuwait bond and sukuk markets include sovereign institutions, quasi sovereign, and corporations. Debt market in Kuwait is still in its development stage and banks loans and IPO's are the main source of funding for companies. There is still much work needs to be done to establish the legal infrastructure to issue sukuk. In the sovereign institutions for bond issues, it is the Central Bank of Kuwait (CBK) that issues bonds on behalf of the State of Kuwait governments and holds the highest position in terms of amounts and number of issues. As such, the sukuk market is still considered very small compared to the conventional bonds.

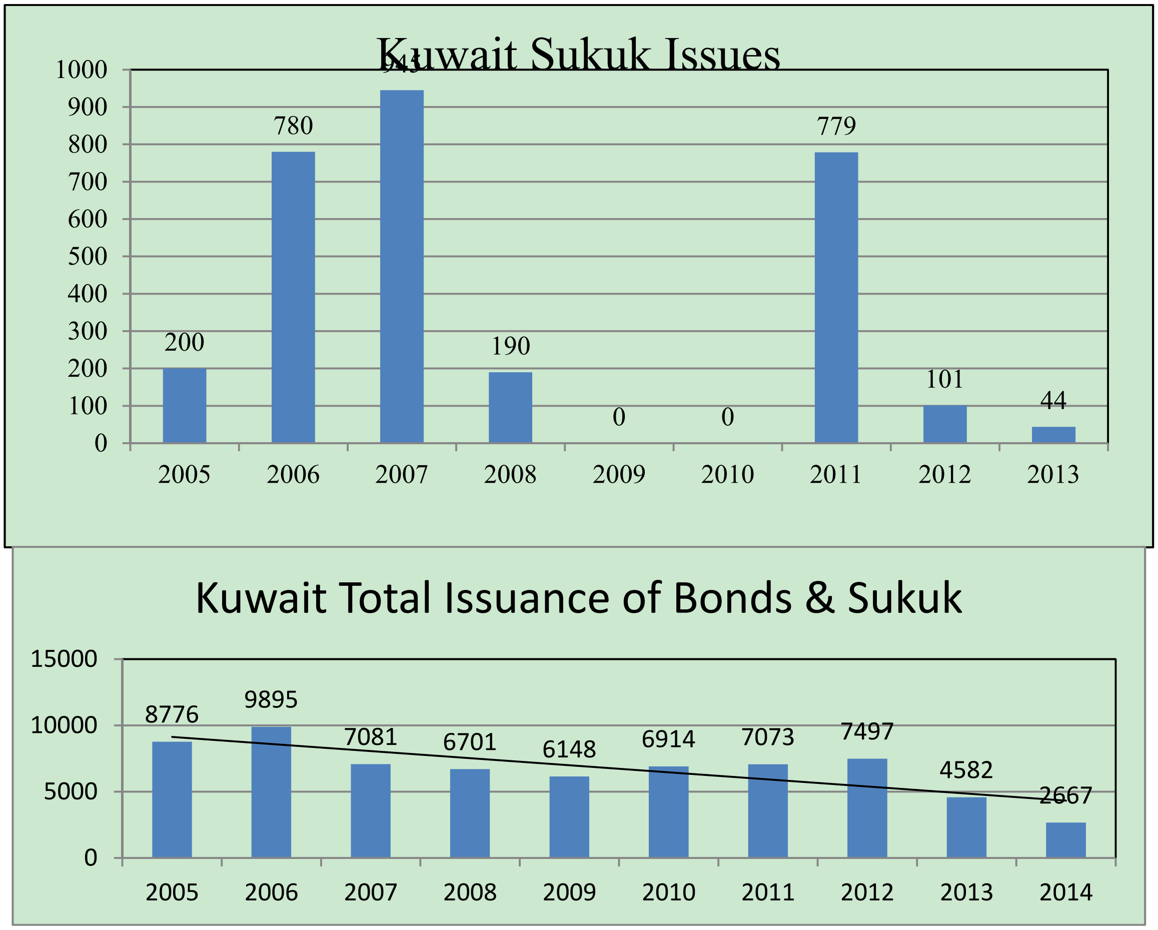
Table 2. Sukuk versus bond

Sukuk Versus Bonds Analysis			
Items	Number of issues	Issue Size ($M)	Average size ($M)
Sukuk	22	3,000.59	136.39
Bonds	336	86,111.43	256.28
Total	**358**	**89,112.02**	**392.67**

Sources: Zawya Islamic data from May -05 to May-2014

As shown in Figure 4 below, the sukuk market has started just recently in the year 2005 when the first sukuk instruments are issued. The total issuance of bonds and sukuk in Kuwait from 2005 until may-2014 is USD 89,112 Million through 358 issues. Bonds issues represent the larger portion of 358 issues compared to sukuk issues of 22. The average size of the bond issue is USD 256.28 million versus USD 136.39 million for sukuk. Central Bank of Kuwait (CBK) bonds issuance (not issuing any sukuk) is the reason for the large difference in amount between the conventional bonds and sukuk. In 2006, Kuwait has experienced the highest percentage increase in bond issues representing a 13% increase from the previous year. In 2006, the total amount of bond issues is worth USD 9,115 million. Investor's confidence declined after 2012 due to Arab Spring, which is reflected in year 2013 that has witnessed a decline of 39 % in the bonds issued compared to the previous year. The total number of issues for both bonds and sukuk has also declined in the year 2013 - from 32 issues in comparison to 45 issues in the previous year. The total value of issues during the 2014 recorded until may-2014 is USD 2,667 million that include only bonds issues for the 16 issues. The Arab Spring has affected both corporate and quasi-sovereign institutions issues. The total issuance for both conventional bonds and Islamic sukuk, the bonds issues include both sovereign states issuance and private companies. The Sukuk issuance includes only quasi-sovereign institutions represented by Gulf Investments Corporation (GIC) and private institutions. Kuwait issues of bond and sukuk in the year 2013 has witnessed a decrease of 27% in comparison with previous year, and this decline is due to great reduction in the Islamic Sharia's sukuk which recorded a drop of 87%. In contrast, the bonds issues had registered only a 39% decline.





Source (Reuters Data)

Figure 4. Kuwait Bond and Sukuk Issue

AL Dar sukuk default has also affected the sukuk issuance in Kuwait. Investors are still waiting to see what would be the result of this default from its restructuring. Kuwait fixed income market for both conventional bonds and Islamic sukuk instruments is comprised of sovereign institutions, quasi-sovereign institutions, and corporations. Figure 5 shows that the sovereign issues represent 73% of the total issues, followed by the quasi sovereign, and the corporates issues. This confirms that the sovereign issues dominate huge parts of the issues and amounts, and this also dominated by the conventional bond issues. Moreover, very limited issues are Sukuk issues. Corporate issues over the past decades have made development in the conventional bonds issues making the bonds market in Kuwait much larger than sukuk.

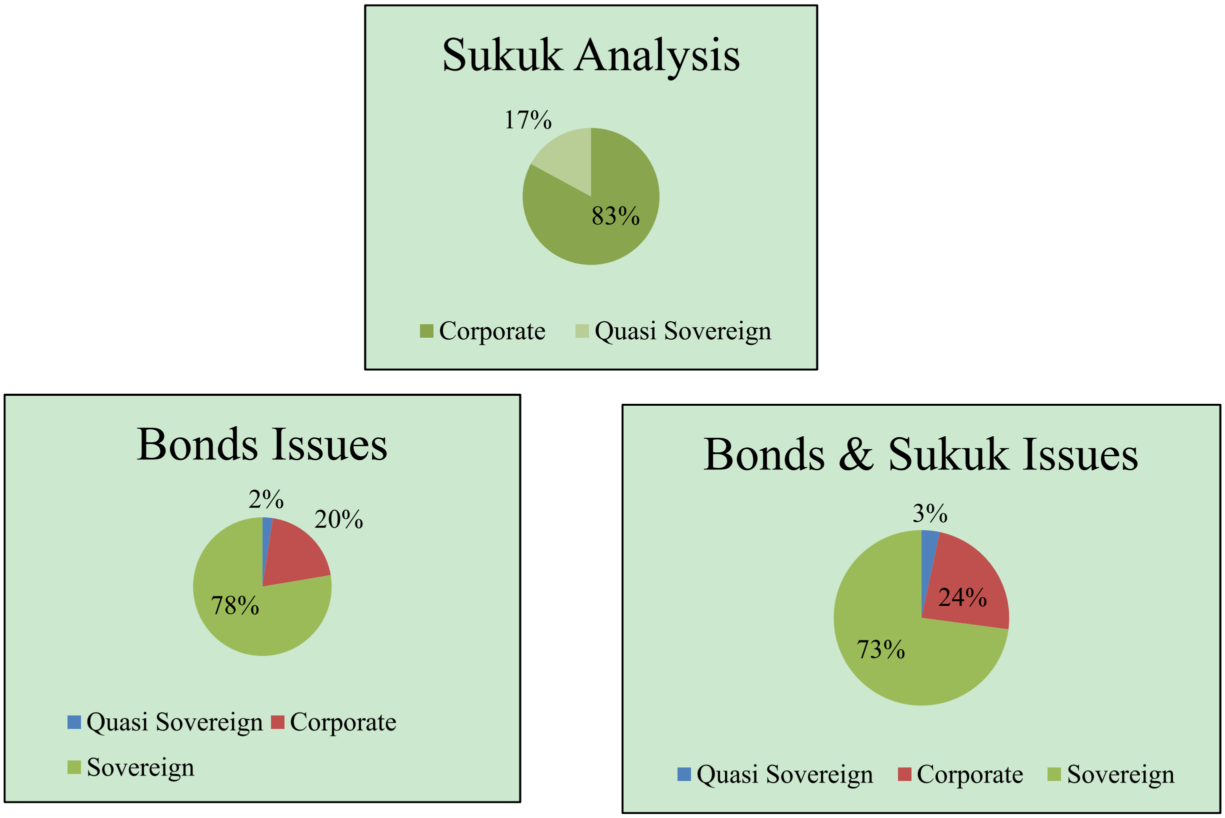


Figure 5

5.2 Sukuk and Its Prospect in Kuwait

Sukuk as an Islamic financial instrument in the fixed income market has been well received by the market participants in global as well as GCC regional markets. Over the past decades, there has been an increase in demand for Islamic financial instruments in general and sukuk in particular in the fixed income market as alternative to traditional bonds instruments. Based on the previous sukuk issues, although the Kuwait market has reacted positively, we have not seen any sukuk issue in the recent year. It comes as a surprise as there are five Islamic banks in Kuwait and 51 Islamic finance companies until 2012 under the supervision of the Central Bank of Kuwait in such a large muslim populated country. The increase in the number of banks that has converted to Islamic banks from conventional banks has made Islamic financial instruments very attractive due to several reasons such as investments, liquidity, and expansions. In addition, Kuwaiti investors who are interested in investing in instruments that follow Shariah principle find the sukuk very attractive alternatives in fixed income market. The comments from the top financial institutions regarding the first Sukuk issue have also been seen as very positive aspect of the instruments.

5.3 Sukuk Defaults in Kuwait and Its Impacts on the Capital Market

Strong interests of Institutions and investors in Islamic financial instruments are mainly due to the fact that the instruments are interest rate free and there is no fixed interest charge to the amount invested. Sukuk is one such Islamic fiancé instruments, which is characterized by the interest-free asset backed instrument. Historically there are 22 sukuk issued in Kuwait from May 2005 until May 2014. Those 22 issues are comprised of different sukuk istruments such as Ijarah, Al-*Istithmar, Al-Wakala Bel-Istithmar, Modarabah, Murabaha, Musharaka,* and *Wakala*. Investors and Islamic financial institutions believe that sukuk has lower risk potential, and would not expect sukuk to default. In 2008, the global economic crisis has put a lot of pressure on the global economy, and has had a negative impact on the Kuwait market as well. The Kuwaiti based company Investment Dar has faced such financial distress and is the first and only one Kuwaiti sukuk issue to default. The sukuk is a *Musharaka* Sukuk with 5 years term with issuing amount of $100 million and with 6-month payment term LIBOR+ 200 bps. On May-12 -2009, Al Dar Investment Company has announced that it has defaulted to pay its periodic payments on its sukuk maturing 2010 (Article Ruters news Tue, May 12, 2009). The default, although only one in Kuwait, has made investors to monitor what would be the best solution for their interest especially the market has not had any experience in dealing with such a default with Sukuk. Al Dar has declared that it would restructure its sukuk to meet its payment of the sukuk. The default of Al Dar sukuk has made it a test for investors to find out how secure is investing in such an instrument, and what would be the best solution for investor to receive back their investments. Investors would be very keen to see and assess how the sukuk issuer reacts and solves such a default. During this period, the company has declared that it would sell some of its assets to meet its obligation. Al Dar investment company has not only defaulted on its first sukuk issue USD100 million but also defaulted on its second USD150 million *Musharaka* Sukuk with 5 years term, which is issued in 2006. In the second sukuk issue, the company is scheduled to make a periodic payment of LIBOR+1.25 for the first 3 years, and LIBIOR+1.75 for the reaming of the term. Interestingly, both sukuk issues are *Musharaka* and both of them are registered outside the State of Kuwait - one in Bahrain Stock Exchange and the other one in the Dubai International Financial Exchange. The default of the Investment Dar sukuk has triggered the concern for Islamic laws for such an instrument. Investors are keen to see the protection right on the Sak they have invested. But as of today no payments has been made by Investment Dar. Al Dar Investment has been discussing its debt restructures just after the financial crisis. The global financial crisis hit the Kuwaiti local banks significantly. To seek the financial stability of its financial sector and economy, government of Kuwait enact a stability Law in April 2009 helping financial institutions affected by the credit crisis.

5.4 Investors' Expectation on Sukuk in Kuwait

Kuwait Sukuk issues have dropped dramatically over the past three years due to the global financial crisis and other technical issues related to Islamic sukuk. The Central Bank of Kuwait should play a pivotal role in issuing sukuk to bring investors' confidence. They have been issuing only conventional bonds which may signal an adverse effect on Islamic financial products. In addition, this also signals the fact that the infrastructure needed to issue a Sukuk in Kuwait market is still emerging. Unlike the conventional finance, where there is fully developed infrastructure to trade and promote their financial products, the Islamic debt market is still in its developing stage in Kuwait and other countries where these instruments are issued. The market would screen the restructuring process for the defaults of sukuk issued by Kuwaiti based company Al Dar investment to assess the real default risk of investing in such instruments.

6. Conclusion

The review of the sukuk literature and Kuwait fixed income market data show that the Kuwait market is influenced by the global economic growth in debt market especially for the introduction of Sukuk. Market participants have used the Sukuk instruments as an alternative to conventional bonds. The sukuk market in Kuwait, though emerged a decade ago, is still at its early stage of growth. During the global financial crisis, Kuwait has experienced one default in sukuk that has been going through a restructuring process to pay off the obligation. The role of government in developing sukuk and other Islamic financial instruments in Kuwait is essential. Without government's support for such instrument it is going to be a challenge for the sukuk to evolve as viable alternative instruments to bond in fixed income market. Recent fast growth in Islamic financial market globally has made sukuk and other Islamic finance instrument more attractive to investors, and Kuwait is not different from other market. Moreover, the limited sukuk issued in Kuwait compared to conventional bonds are due to the (1) the lack of expertise in the field of structuring sukuks compared to conventional bonds, (2) there is not sukuk issuance represented by the central bank of Kuwait compared to bonds issues, and (3) investors are still waiting to see what happens to the first sukuk default by AL Dar Investment Company. Kuwait debt market needs to be developed especially for those Islamic instruments, and sukuk in more developed markets. However, until the country laws and regulation show to investors and participants that the country is ready for sukuk issuance and structure is developed, one cannot predict how far this market can evolve in the future.

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