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Challenges for the Issuers to Issue Global Hybrid Sukuk that Complies with AAOIFI Shari'ah Standard No. 59

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Abstract

Hybrid sukuk is a structure preferred by issuers in the global sukuk market. It requires a lower tangibility ratio requirement, i.e., at a minimum of 30% of the total sukuk issuance amount, while receivables from a commodity *Murabahah* transaction can cover the rest. However, this changes with the implementation of Shari'ah Standard no. 59 on the Sale of Debt by the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI")("S59"). It mandates a higher tangibility ratio requirement of more than 50%, which has to be maintained throughout the sukuk period. When it breaches the 33% tangibility ratio, it must be delisted and traded according to the *Bay' al-Dayn* rules. The initial market reactions were negative, and the number of sukuk issuances decreased, especially in the UAE. Many pointed out that the implementation of S59 led to this situation. There are numerous challenges for the issuers to comply with S59, such as the lack of tangible assets to comply with the higher tangibility ratio, additional complexity in structuring a sukuk, maintaining the tangibility ratio, and incorporating the delisting event clause into the documentation.

Keywords: *Islamic capital market, Sukuk structuring, Hybrid sukuk, AAOIFI Shari'ah standards, Sale of debt*

1. Introduction

Sukuk has gained popularity in both local and international financial markets. It is an attractive funding source for various entities, including governments, companies, and sovereign wealth funds. Investors are drawn to sukuk due to its ability to diversify risks, provide fixed-income assets, and attract both Islamic and non-Islamic investors ("Islamic investors" are referring to both Muslims individuals and Islamic institutional investors). Global sukuk issuances are frequently oversubscribed, especially those that are originated from Malaysia and Indonesia. Institutional investors prefer sukuk because they offer stable returns and positive growth effects, making them ideal for long-term investments. (Bakar, 2017; International Islamic Financial Market, 2022; Wan Mohamed Ali, 2014).

The demand for sukuk has also increased due to Islamic financial institutions (IFIs) using it as a liquidity management tool. Sukuk has been established as a Shari'ah-compliant financial instrument that offers similar features to conventional bonds. The sukuk industry has seen significant growth in recent years, and in 2020, sukuk issuances reached USD 174.60 billion, despite the challenges posed by the Covid-19 pandemic. Leading players in the industry include Malaysia, Saudi Arabia, UAE, Bahrain, Indonesia, Turkey, Pakistan, and Qatar. The global sukuk industry has experienced a compound annual growth rate of 26%, and as of the first half of 2021, the value of global sukuk outstanding was USD 630 billion (Dinar Standard, 2022; International Islamic Financial Market, 2021).

Sukuk structures and features have evolved to meet the demands and development of the financial market. Sukuk started with a single Shari'ah contract only. Then, sukuk has undergone significant Shari'ah dynamism and innovation, with developments and innovations aligned with issuers' requirements and needs. Over time, various concepts and Shari'ah principles were introduced based on issuers' different needs and preferences.

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Common sukuk structures are based on *Mudarabah, Musharakah, Wakalah, Ijarah, Murabahah, Salam, Istisna',* and *Bai'Bithaman Ajil*. The underlying Shari'ah contracts are applied to structure various commercial-based innovations in the market, such as senior unsecured sukuk, perpetual sukuk, convertible sukuk, exchangeable sukuk, and subordinated sukuk. Shari'ah Standard No. 17 on Investment Sukuk provides numerous types of sukuk structures. However, hybrid sukuk remains the most popular structure (Bakar, 2017; Hanefah et al., 2013; ISRA, 2017; Wan Mohamed Ali, 2014; Wilson, 2004).

2. Why is Hybrid Sukuk Preferred over other Sukuk Structures?

It is essential for the issuer to meet the requirement of providing sufficient underlying assets to issue a sukuk. However, this can be challenging for potential issuers due to various factors. These factors include the inability to provide enough unencumbered assets that match the sukuk issuance amount, the complexity or unsuitability of the assets for a sukuk issuance, and constraints in selling the assets to sukuk holders due to standard negative pledge provisions provided to earlier creditors. Among asset-backed sukuk and asset-based sukuk, issuers generally prefer the latter due to the constraints and requirements of the asset-backed sukuk structure discussed earlier. Nonetheless, even with asset-based sukuk such as *Ijarah* sukuk, issuers must provide Shari'ah-compliant assets with a value comparable to the total issuance amount. The assets must exist during the issuance and throughout the sukuk tenure (ISRA, 2017).

Hybrid sukuk has become popular in recent years because it offers flexibility in structuring the sukuk using different Shari'ah contracts based on the issuer's preference. This type of sukuk also addresses the issuer's limitation in providing tangible assets as the underlying assets. The issuer only needs to provide assets with a value equivalent to 51% or 30% of the total sukuk issuance amount, while the rest of the percentage is covered by the receivables from the sale of commodities. It means the issuer doesn't need to provide 100% of the value of tangible assets, unlike other types of sukuk. For example, for a USD1 billion nominal value of hybrid sukuk, the issuer only needs to provide tangible assets worth USD300 million (applying the 30% tangibility ratio). The issuers can choose any type of tangible assets they prefer or what they have at the point of issuance. This flexibility is crucial for issuers as the availability of underlying assets is critical in enabling them to issue a sukuk. Besides that, the issuer must also be willing to set the assets aside during the sukuk tenor (Bakar, 2017; Haneef, 2015; ISRA, 2017).

There have been a lot of innovations in structuring hybrid sukuk in the global sukuk market, especially on the tangible asset portion, as per the following Table 1.

Table 1: Innovations in hybrid sukuk

Sukuk	Issuance Year	1st Sukuk Component	2nd Sukuk Component
Malaysia Sukuk Global Berhad	2016	Vouchers representing travel entitlements	Shari'ah-compliant shares
Dar Al Arkan	2017	*Ijarah* assets	*Murabahah* receivables
Sharjah Sukuk Programme Limited	2017	*Ijarah* assets	*Murabahah* receivables
KSA Sukuk Limited	2017	*Mudarabah* agreement, a form of Islamic investment management partnership	*Murabahah* receivables
Apicorp Sukuk Limited	2017	*Wakalah* Assets that are *Ijarah* Assets and/or tangible *sukuk*	*Murabahah* receivables

Source: Respective sukuk's information memorandum or offering circular

According to the 2021 report on Sukuk by IIFM, 51% of the global sukuk issuances in 2020 were in the form of sukuk *Al Wakalah*, which is a hybrid sukuk that combines *Ijarah* with *Murabahah*. Meanwhile, other forms of hybrid sukuk accounted for 13.17% of the total international sukuk issuances in 2020 (International Islamic Financial Market, 2022). The report also outlines various asset combinations of contracts for hybrid sukuk, which are: 1. *Murabahah* and *Ijarah* 2. *Murabahah* and *Mudarabah* 3. *Murabahah* and *Wakalah*, and 4. *Ijarah* and *Musharakah.*

3. The New Tangibility Ratio Requirements by Standard 59

Among existing AAOIFI Shari'ah standards relevant to sukuk structuring are Shari'ah Standard No. 17 on Investment Sukuk and Shari'ah Standard No. 21 on Financial Paper. Recently, the sukuk industry welcomed another Shari'ah standard by AAOIFI relevant to sukuk structuring in the form of Standard 59 on the sale of debt ("S59"). The compliance deadline was 1st January 2021 for the country that adopts AAOIFI on a mandatory basis, such as the UAE. S59 provides relevant requirements for the sale of debt. It discusses, among others, the definition of debt, types of sale of debt, rules on the sale of debt, and the contemporary application of the sale of debt (AAOIFI, 2018).

Two notable areas where the adoption of S59 will affect the Islamic finance industry's existing practices are the rollover of debt-based financing and the trading of sukuk, which contains the element of debt. The latter would be the focus of this paper. The following Table 2 summarizes the new requirements by S59 relevant to structuring hybrid sukuk and the comparison with the previous practices in the sukuk industry:

Table 2: Comparison between the requirements of S59 and the practice before the implementation of S59

New Requirement by S59	The Practice Before the Implementation of S59
The tangibility asset ratio shall exceed 50%* and has to be maintained throughout the sukuk period ("tangibility ratio"). **For ease of reference, herein will be referred to as 51%. Because 50.00000001% or similar numbers also satisfied the requirement but is very hard to be used as a reference in this paper.*	51% or 30% ratio of tangible assets No provision that requires maintaining any tangibility ratio throughout the sukuk period
If the tangibility ratio falls below 51%, it has to be brought up to the allowable ratio (51%) within the period prescribed by the Shari'ah advisor.	No provision that requires maintaining the tangibility ratio throughout the sukuk period
Suppose the tangible asset ratio falls below 33%. In that case, the issuer has to advertise/inform the sukuk holders that the sukuk cannot be traded, except by following the Shariah rules on debt trading (at par only). If the sukuk is listed on any exchange, it has to be delisted.	No provision that requires maintaining the tangibility ratio throughout the sukuk period No provision that requires the sukuk has to be delisted

Source: Authors' own

This paper will refer to the above requirements as the tangibility ratio requirements by S59 ("S59 TRRs"). According to ISRA (2017), the key Shari'ah requirements in structuring sukuk are:

1. Shariah-compliant contracts
2. Shariah-compliant underlying assets
3. Shariah-compliant utilization of proceeds
4. Redemption and trading of sukuk in line with Shari'ah

Based on the above key Shari'ah requirements, the implication of S59 for structuring hybrid sukuk is related to the underlying assets and tradability of sukuk.

The implication of S59 towards the underlying assets requirements for hybrid sukuk

S59 has increased the asset tangibility ratio requirement for sukuk issuers from 30% to 51%, which significantly impacts the amount of underlying assets needed for a USD1 billion sukuk issuance, for example. Additionally, the 51% asset tangibility ratio must be maintained throughout the whole sukuk period. It could be challenging as the underlying tangible assets are open to various risks affecting their value. Before S59, the issuer only needed to bring the value up to 51% on a best-effort basis, and there was no strict requirement when the value depreciated below 51% i.e., RM510 million. However, S59 requires the issuer to bring the value up to 51% within a specified period as their Shari'ah advisor advises when the value depreciates below RM510 million (Itam et al., 2022).

The implication of S59 towards the tradability of hybrid sukuk

Sukuk and bonds are traded in the secondary market, allowing investors to liquidate their investment before the maturity of the sukuk. This feature is vital for liquidity management, especially for Islamic banks. The tradability of sukuk is guided by the relevant Shari'ah principles or standards, with each sukuk structure subject to applicable rules concerning tradability. For example, *Murabahah* sukuk, which represents 100% commodity *Murabahah* receivables, is among the preferred structure in Malaysia. The Shariah Advisory Council of the Securities Commission Malaysia allows the application of *Bay' al-Dayn* in the Islamic capital market. However, under AAOIFI Shari'ah Standard no. 17 on Investment Sukuk, *Murabahah* certificates are not allowed to be traded after the delivery of the *Murabahah* commodity to the sukuk investors.

By virtue of S59, if the ratio of a hybrid sukuk goes below 33%, the sukuk must be traded according to the sale of debt rules and must be delisted if listed on any exchange. The delisting event provides additional risk for sukuk holders, resulting in a lack of interest in the book-building exercise and ultimately leading to a higher funding cost for the issuer (Itam et al., 2022).

4. Research Methodology

The author conducted semi-structured interviews ("SSI") to understand the challenges faced by the issuers to comply with the requirements under S59 to structure a hybrid sukuk. SSI is a primary data collection method under the case study strategy. SSI is frequently the sole data source and the most widely used interviewing format for a qualitative research project due to its versatility and flexibility (DiCicco-Bloom & Crabtree, 2006; Kallio et al., 2016). It allows the chance to 'probe' answers, where the interviewer wants the interviewees to explain, or build on, their responses (Saunders et al., 2009).

SSI is conducted around a set of predetermined open-ended questions, with other questions pursuant to the conversation between the interviewer and the interviewee(s) (DiCicco-Bloom & Crabtree, 2006). It could also be conducted with a blend of closed and open-ended questions, usually with why or how questions (Adams, 2015). The interviewer can ask follow-up questions based on the interviewees' responses (Kallio et al., 2016). According to Saunders et al. (2009), an interview is also suitable when the questions are complex or open-ended. Since complex questions potentially produce complex answers, this format is also preferable for the interviewees, as they only need to speak rather than write the answer themselves. All these elements were applied in this research.

Therefore, the researcher believes SSI would be the best method for collecting the data to investigate the challenges for the issuers to comply with S59. According to Silverman (2004), what is important is to generate data that provides authentic insight into people's experiences. Thus, SSI is suitable for addressing the niche section this research investigates. The open-ended questions also fit the interviewees' size and allow them to provide an unrestricted opinion and view on the questions asked.

The researcher identified and interviewed various experts in the sukuk industry with relevant working experience and knowledge of structuring global sukuk. The interviews were conducted via physical engagement or online platform. The interviews were conducted from July 2022 until April 2023. Research protocol or interview questions were drafted to guide the researcher to conduct the interviews. The researcher adjusted interview questions based on factors like the interviewee types and the timing/situation of the interviews. Different questions were asked to different interviewees based on their expertise and role. Additionally, the research protocol was summarized to accommodate the busy schedules of interviewees, with specific emphasis given to relevant topics based on their availability.

For clarification, the questions asked to the interviewees also covered other areas related to the implementation of S59 in sukuk structuring. The questions are related to the challenges for the investors to comply with S59, the impacts of S59 on the market, and the proposed solutions. However, these will be covered in other papers to be published by the researcher. This paper will focus solely on the challenges faced by the issuers to issue global senior hybrid sukuk that complies with S59.

The author interviewed 26 experts comprising investment bankers, Shari'ah scholars, and various industry experts involved in the sukuk structuring process. As the research scope concerns sukuk that are subject to or intend to comply with the AAOIFI Shari'ah standards, the interviewees were mainly based in the GCC countries. However, there were also interviewees who were not based in the GCC countries but still had experience with dealing, structuring, and/or advising global sukuk that aim to comply with the AAOIFI Shari'ah standards.

The following are the explanation about the interviewees based on their respective category and their relation to the issue in this research.

a. Investment Bankers

Investment bankers act as an intermediary between issuers and investors. They are involved in the end-to-end sukuk issuance processes. Thus, they understand the mechanics of advising the best structure for a sukuk while meeting the relevant legal, regulatory, and Shari'ah requirements, including S59. They also have to consider issuers' capability to satisfy the proposed structure and ensure that investors have an appetite for such a sukuk structure. Thus, they understand the challenges and implications for both issuers and investors. The interviewees under this category were chosen based on their experience in dealing with global sukuk issuances.

This is because global sukuk typically need to consider the interest of Middle Eastern investors, who predominantly rely on the AAOIFI Shari'ah standards. The researcher interviewed two investment bankers from the UAE and one from Qatar.

b. Rating Agency

A rating agency is a firm that evaluates and provides an assessment of credit risk associated with the parties involved in sukuk transactions, as well as the overall sukuk structure. They provide their opinion during or after the issuance of the sukuk. The rating agency is also responsible for evaluating the impact of the underlying structure on the sukuk ratings, taking into consideration factors such as S59. Both S&P Global Ratings and Fitch Ratings have made several comments regarding the implementation of S59 (Fitch Ratings, 2021; Islamic Finance News, 2021b). Therefore, it is appropriate to request a comprehensive opinion from rating agencies regarding this issue. For this research, representatives from two global rating agencies were interviewed.

c. Shari'ah Advisers and Shari'ah Scholars

Shari'ah advisers and Shari'ah scholars ("Shari'ah advisers") advise on Shari'ah matters for sukuk structuring. Before a sukuk is issued, the issuer (through their principal adviser or investment banker) must obtain Shari'ah approval from the Shari'ah advisers, certifying the sukuk's structure, mechanism, and documentation are Shari'ah-compliant. The Shari'ah advisers must also advise and confirm whether the sukuk complies with the relevant Shari'ah standards and regulations. In the context of AAOIFI Shari'ah standards, the Shari'ah advisers have to ensure that the sukuk complies with the AAOIFI Shari'ah standards if the issuer opts to comply with the standards. Seven Shari'ah advisers and Shari'ah scholars were interviewed for this research, which most of them have experience in advising global sukuk issuances.

d. Shari'ah Department Officers of an Islamic bank

There are two methods through which Shari'ah advisers can provide approval for a sukuk. The first method involves a direct and personal appointment of the Shari'ah adviser by the issuer, as mentioned above. In this arrangement, the Shari'ah adviser engages with the issuer, thoroughly examines the documentation, and provides a Shari'ah pronouncement for the sukuk using their own name.

The second method involves appointing an Islamic bank as the Shari'ah adviser for the sukuk. Islamic banks often have their own Shari'ah advisers who provide guidance on various products and services offered by the bank, including sukuk. In this case, the Islamic bank itself is named as the Shari'ah adviser, rather than an individual Shari'ah adviser.

The officers from the Shari'ah department of the Islamic bank serve as the primary point of contact for any Shari'ah-related matters. They engage directly with the issuer, review the draft documentation, and prepare the Shari'ah pronouncement. The final documents and draft Shari'ah pronouncement are then reviewed and signed by the Shari'ah advisers of the Islamic bank.

It is worth noting that although the interviewees in this category primarily represent the head of the Shari'ah departments, they can also be considered as investment bankers due to their involvement in the end-to-end processes of sukuk structuring. Three Heads of Shari'ah department (from the UAE and Malaysia) were interviewed for this research.

e. Fund Managers or Treasurers
Due to the minimum investment amount required for a sukuk, most sukuk investors are institutional investors. The investment is performed by their fund managers or treasurers (for banks). Thus, interviewing them provides critical insight from the investors' perspective. Four fund managers (one from the UAE and the rest from Malaysia) were interviewed for this research.

f. Other Experts
The researcher also interviewed other relevant experts to obtain their insight on the issue, such as interviewees from the exchange company (for listing purposes), liquidity management institution, and law firm.

5. Challenges for the Issuers to Issue Global Sukuk that Complies with S59

Issuers have to consider various factors before deciding to issue a sukuk, such as the purpose for raising the fund, how much they need, and the required sukuk issuance processes and procedures. During the sukuk issuance journey, it is logical that the issuer expects the processes to be as smooth as possible without encountering any problems and affecting the main objective of issuing a sukuk, i.e., to obtain Shari'ah-compliant funding at a competitive or cheapest cost. Thus, the question is how the implementation of S59 will synergize with the existing sukuk issuance processes and whether it will pose any challenge to the issuers. Based on the interviewees' feedback, the following are the challenges the issuers face with the implementation of S59.

Challenge No. 1: Adopting the new tangibility ratio requirements
Adopting the new tangibility ratio requirements by S59 ("S59 TRRs") is the first challenge the issuers must address. Before the implementation of S59, the higher 51% tangibility ratio was not a requirement but rather a best practice. Additionally, there was no rule regarding a delisting event. The interviewees' feedback reveals a lack of understanding about the new requirements, requiring extensive explanation and awareness efforts. Educating issuers and rating agencies can be challenging and time-consuming, especially when dealing with new regulations or standards. Therefore, the market players require more time to understand the new requirements, and a gradual implementation of S59 has been proposed.

When S59 came into effect, there was no implementation period provided to the industry. S59 was only endorsed in December 2018 and came into force in January 2021 (AAOIFI, 2018). It means the industry had about two years only to familiarise itself and implement S59. Given the gravity of the S59 TRRs, it was way too short for the industry, as mentioned by the interviewees. Some interviewees stressed that the industry should be given around three years to comply with such requirements.

As a comparison, even the Basel Committee gave the industry a lot of time to comply with their requirements. Singh and Gupta (2017) stated that the implementing banks and financial institutions faced issues and challenges with the recommendations and implementation of Basel 3 as they needed to make macro adjustments and reorienting monetary policies. The central banks were required to suitably formulate the monetary policy and plan needed strategies and provisions considering the overall situation of banking systems and the state of the economy.

The nature of sukuk issuance, including the short window to enter the market, further complicates the adoption of S59. Market timing is critical, and delays may result in issuers switching to issuing conventional bonds. If issuers encounter issues like the implementation of S59, the interviewees mentioned that the issuers might easily opt for conventional bond.

Challenge No. 2: Lack of tangible assets to comply with the higher tangibility ratio
Global sukuk involves raising millions or billions of dollars. Sukuk issuance requires underlying assets, including hybrid sukuk. The issuers sometimes could not provide enough assets to match the issuance amount. Governments also hesitated to allocate public assets to foreign investors (when made as the underlying assets) because it could be seen negatively. Therefore, increasing the tangibility ratio to 51% makes it even more challenging for issuers to provide the required assets. For example, for a USD1 billion issuance, providing assets worth USD510 million (to comply with the 51% tangibility ratio) is way more difficult than providing assets worth USD300 million (30% tangibility ratio as per the practice before S59).

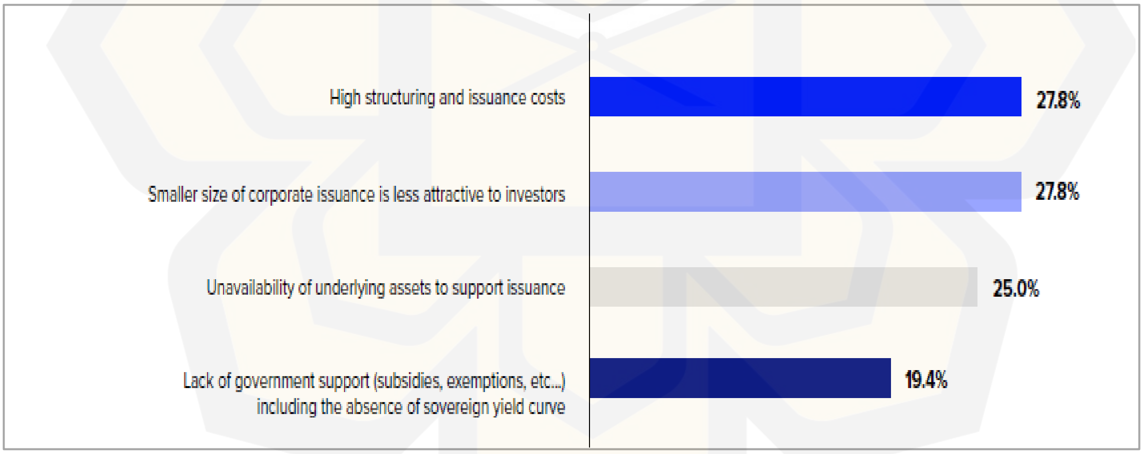
The interviewees experienced deals that were put on hold or cancelled due to the higher tangibility ratio required by S59. It supports S&P Global Ratings' forecast that the sukuk route may become less attractive due to challenges related to the availability of assets on issuers' balance sheets (S&P Global Ratings, 2022). Investment bankers consider the issuer's capability to provide sufficient assets when advising potential issuers who may be interested in issuing sukuk but lack the necessary underlying assets. As mentioned by Itam et al. (2022), the incapability to provide enough underlying assets was the reason why hybrid sukuk was introduced to the sukuk market and why the lower 30% tangibility ratio has been adopted in the market.

According to a survey conducted by ISRA-Deloitte, 41.41% of respondents strongly agreed that the lack of suitable underlying assets and legal restrictions in asset ownership had caused practical difficulties in issuing sukuk, and the other 49.49% of respondents agreed to an extent (Deloitte, 2018). Thus, this is a common challenge that applies globally. The higher tangibility ratio provides different challenges for two types of issuers: corporates and financial institutions.

Corporate Issuers

For corporate issuers (non-financial institutions), when they need funding for their operations, they can obtain financing from banks or issue new shares. Still, both exercises could be expensive and dilute existing shareholders. Sukuk can be a better option for corporates to get funding at a lower cost. However, the interviewees confirmed that the requirement for a higher tangibility ratio could be a problem, especially for asset-light companies that don't have enough suitable assets. It has also been confirmed by Refinitiv's 2021 Sukuk Perceptions and Forecast Study. It is stated in the report that the higher tangibility ratio limits the issuer's ability to leverage up, so they may choose to issue conventional bonds instead, which hurts the sukuk supply (Refinitiv, 2021).

Figure1: Refinitiv sukuk survey on "What is the main hurdle limiting corporate sukuk issuance growth?"



Source: Refinitiv (2021)

The following is the data for the global sukuk market from 2010 until 2021 (International Islamic Financial Market, 2022):

Figure 2: International Sukuk Issuances from 2010 until 2021

Source: International Islamic Financial Market (2022)

Note that the percentage of corporate issuances went from 17.02% (2010-2019) to only 2% in 2021. It is clearly not good for the Islamic finance industry, as the number of global corporate sukuk issuances is near zero percent. An interviewee also mentioned that the impact of S59 has already happened, i.e., the elimination of small corporates' ability to enter the sukuk market. As a comparison, Malaysia has various corporate sukuk issuers, i.e., from asset-light to asset-heavy issuers. According to Securities Commission Malaysia (2022), corporate sukuk forms 82% of the total corporate bond and sukuk outstanding as of May 2022, and corporate sukuk forms 80% of the total corporate bond and sukuk issuance in 2021.

Financial Institution Issuers

Another type of issuer that could be affected by the higher tangibility ratio requirement is the financial institutions ("FIs"). According to Refinitiv (2022), the FIs typically account for most sukuk issuances (FIs and non-FIs), contributing 65% of the USD38.1 billion global sukuk issuances in 2021.

The struggle depends on the financial assets the FIs' have on their balance sheet. To explain this, let's say that a financial institution (such as Islamic bank) has *Ijarah* financial assets only, valued at USD3 billion. Suppose the financial institution wants to issue a sukuk worth USD500 million. In that case, they can easily issue a hybrid sukuk or even a full *Ijarah* structure due to the availability of their *Ijarah* assets. The *Ijarah* assets are considered tangible assets because the assets represent ownership in the underlying *Ijarah* assets, not the rental receivables.

However, the situation gets complicated if their financial assets are based on various Shari'ah contracts such as *Ijarah*, *Mudarabah*, Commodity *Murabahah,* or plain *Murabahah*. It is the case for almost all Islamic FIs. Furthermore, a big chunk of financial assets owned by most Islamic banks, be it from Malaysia or the GCC countries, are based on *Murabahah* or *Tawarruq* (intangible assets). In Bahrain, retail and wholesale Islamic banks utilize *Murabahah* for their financings at 51.0% and 65.3% out of total financings, respectively. While in Saudi Arabia, the main financing instruments of the full-fledged Islamic banks were based on *Murabahah*

(69%), *Tawarruq* (19%), and *Ijarah* (11%). For the Saudi Islamic banking windows, their financings used *Tawarruq* (59%), *Murabahah* (27%), and *Ijarah* (11%) (Islamic Financial Services Board, 2022). In Malaysia, *Tawarruq* forms 57.23% of Malaysia's total Islamic financing assets as of August 2022 (Bank Negara Malaysia, 2022). There is no collective data for the UAE, but *Murabahah* forms 69.66% of First Abu Dhabi Bank's Islamic financing assets (First Abu Dhabi Bank, 2021). Thus, most of them might have problems providing enough underlying financial assets for hybrid sukuk issuance, especially with the higher tangibility ratio required by S59.

Tawarruq or *Murabahah* assets are not considered tangible assets because the assets represent receivables to be received by Islamic banks. Thus, they could not form part of the tangibility ratio under a hybrid sukuk structure. Since the Islamic FIs' financial assets are concentrated in *Tawarruq* or *Murabahah*, they may have limited capability to make their financial assets the underlying asset for a sukuk issuance unless their tangible financial assets, such as *Ijarah* financings are large enough in their balance sheet to cover the whole sukuk issuance.

An interviewee mentioned that IFIs rely on sukuk to fund their business activities in addition to customer deposits. Access to sukuk is crucial to ensure the competitiveness of Islamic FIs. Islamic banks need sukuk to manage their liquidity and comply with regulations, including Basel 3 requirements, which mandate a credit facility. However, many credit facilities are structured using *Tawarruq* or *Murabahah*.

Challenge No. 3: Additional complexity

In sukuk issuance processes, it is required to establish a special purpose vehicle (onshore/offshore), identify eligible assets, obtain regulatory and government clearances, additional structuring, and receive approval from Islamic scholars' rulings (*Fatwas*). As a result, sukuk offerings may take longer to structure and document than ordinary conventional bond offerings (Khnifer, 2023).

ISRA (2017) also stated that sukuk is inherently more complex and challenging. In the early days of sukuk, there was no choice but for the government and government-linked entities to invest in launching a sukuk and kickstart the Islamic capital market. In the Malaysian context, for example, issuers have been incentivized with tax benefits to compensate for their extra work and cost.

An interviewee explained that due to the implementation of S59, new issuers must adapt to the new legal environment, identify assets, become familiar with structures, and prepare additional legal documents. This involves redoing documentation and testing structures (as provided by the documentation), all within a short timeframe before going to the market. As mentioned before, given the limited market timing window, it is crucial for issuers not to waste time on extensive documentation changes before going to the market.

Due to the additional complexities and works, the issuer could also incur more fees for the services and advices by investment bankers and lawyers. According to an interviewee, the issuers do not want to incur the costs and expenses of rewriting their entire sukuk program. The additional complexities and works also mean that investment bankers and lawyers need time and effort to educate the issuers and the related parties (e.g., regulators, rating agencies, and investors) about the change in the sukuk's nature with the adoption of S59 requirements.

According to another interviewee, many issuers have expressed that they are willing to forego two or three onshore accounts in the UAE if it requires a lot of legal work to amend their program and documentation. Foregoing the UAE accounts means the issuers have no problem not adopting S59 due to the additional legal work. It shows that incorporating S59 requirements is very burdensome and that the issuers are willing to face the risk of higher pricing due to the non-participation of the UAE investors in the book-building process.

An interviewee mentioned that the S59 issue makes issuing sukuk more complicated than issuing conventional bonds, which can be a barrier for new market players trying to enter the sukuk market. Some emerging markets have even cancelled their sukuk plans because of this additional complexity.

Challenge No. 4: Maintaining the tangibility ratio

As mentioned above, maintaining the 51% tangibility ratio is a requirement under the S59 TRRs. When the 51% tangibility ratio is breached, the issuer still has to restore the ratio as per the time as advised by their Shari'ah advisor. The worst-case scenario would be breaching the 33% tangibility ratio. If breached, it can only be traded according to *Bay' al-Dayn* rules and must be delisted by the issuer from the exchange. It is also called as a partial loss event. Previously, there was only a total loss event where the sukuk would collapse if the underlying tangible assets lost their total value.

The interviewees noted that the issue with S59 is whether the issuer can comply with the tangibility ratio throughout the sukuk period. The assets' value might fluctuate due to the market conditions. Maintaining and monitoring the tangibility ratio result in extra work for the issuers or additional costs if they outsource the work. Sheikh Dr. Bashir Aliyu, a global Shari'ah scholar, supported this. He said it is a challenge for the issuers to bring the asset pool to the level of tradability to meet the specified standard (Kuala Lumpur Islamic Finance Forum, 2022).

There is no issue with the requirement of maintaining the tangibility ratio. However, we must be more understanding of the issuer, especially when a significant punishment awaits them if the 33% tangibility ratio is breached, i.e., the delisting event (to be discussed in challenge seven why it is a "punishment"). Providing enough underlying assets is already a big challenge for most issuers (as discussed before). Indeed, maintaining the tangibility ratio would be an additional requirement that the issuers must keep in mind. An interviewee also reminded that the tangibility might drop due to external issues beyond the issuers' control, such as the global economic crisis. In this situation, the issuer genuinely requires more time to fix the problem.

Monitoring the tangibility ratio could be translated to additional costs to perform the role. Based on the prospectus of sukuk issued by the Government of Sharjah, it states the following (Sharjah Sukuk Programme Limited, 2021):

> *"The Servicing Agency Agreement provides that the Servicing Agent shall appoint, and maintain the appointment of, the Shari'ah Adviser to monitor the compliance with AAOIFI Shari'ah standards of the Transaction Documents and the Trust Certificates and to advise on any matters requested by the Servicing Agent (acting in any capacity under the Transaction Documents)."*

Indeed, the "monitoring" role will not be for free. The above sukuk complied with the tangibility ratio requirements as required by S59. An interviewee mentioned that, in practice, when a Shari'ah advisor for a sukuk is appointed, the mandate and fee are up to the point of sukuk issuance only. Thus, any post-issuance responsibilities (the monitoring role) may incur additional costs to be paid to the Shari'ah advisor, especially when the sukuk tenure is long.

Challenge No.5: Struggle for the non-UAE issuers

The UAE remains one of the strongest Islamic finance jurisdictions in the Gulf region and globally, particularly in the banking and capital markets (Islamic Finance News, 2021a). The UAE ranked fourth behind Malaysia, Saudi Arabia, and Iran, in the Islamic finance category in the State of the Global Islamic Economy Report 21, with a record of USD251 billion in Islamic finance assets in 2021 (Dinar Standard, 2022). According to Islamic Financial Services Board (2021), its Islamic banking asset shares form 20% of total banking assets domestically and 9.2% globally (behind Iran, Saudi Arabia, and Malaysia). Hence, there is a lot of Islamic liquidity (sukuk investment) in the UAE that issuers cannot overlook when issuing a global sukuk. Global sukuk is usually denominated in USD and targeting investors globally.

According to the interviewees, non-UAE issuers have to comply with S59 if they are chasing the anchor investors from the GCC markets for their USD sukuk issuance, where most of them are from the onshore UAE, such as Dubai Islamic Bank, Abu Dhabi Islamic Bank, and other large Islamic banks. There is no problem if the issuers are from Asia, such as Malaysia or Indonesia. But, if the issuers are from the GCC, it will make a lot of difference. They expect to attract anchor investors from within the region (especially from the UAE) after they price and market their global sukuk. The larger accounts are from the onshore UAE accounts.

The above responses depict the undeniable importance of Islamic liquidity available in the UAE. It is safe to say that there would be a loophole in the issuer's strategy if they were issuing a global sukuk without targeting the UAE investors. The potential investors' size from the jurisdiction will undoubtedly contribute to tightening the sukuk price further during the book-building process. The higher the participation in the book-building exercise, the lower the funding cost for the issuer.

An interviewee confirmed that when issuing a sukuk, the issuers are concerned about how much they can raise and at which price they can raise it. These two factors are affected by the number of book-building participants. Hence, simply omitting the UAE investors is not easy for issuers. The book-building exercise aims to ensure that the issuers get the lowest funding cost for their sukuk. An interviewee stated that he had an experience where the issuer insisted on including the UAE because they want the book-building participation to be as broad as possible.

Another reason why non-UAE issuers could not miss the UAE market is because of the available USD liquidity in the UAE, as mentioned by an interviewee. The top 3 jurisdictions that are rich in USD Islamic liquidity are the UAE, Kuwait, and Qatar. When the liquidity is already in the form of USD, it means the investors do not have to hedge the currency risk. Though there is a lot of Islamic liquidity in other regions, for example, Malaysia, they may not be in USD. Investors (where their liquidity is in RM for instance) must hedge their USD investment (buying a global sukuk) via forex exchange instruments. Buying a global sukuk involves hundreds of millions of USD. There might be a limited size of Islamic forex exchange instruments that the IFIs in Malaysia can offer (due to their risk and reward in offering the instruments). So, this could pose a challenge for the investors, especially the institutional investors, whose liquidity is not in USD. It stresses the importance of investors from the UAE.

Challenge No. 6: Struggle for the UAE issuers

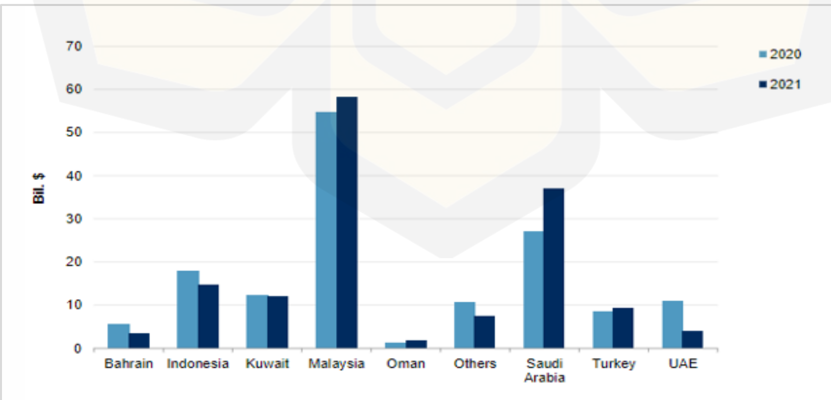
Dubai is the world's largest centre for sukuk listings at USD 51.21 billion and has overtaken other financial centres in listing sukuk on its exchanges. The UAE was the second largest sukuk issuer in 2020 but dropped to fourth in 2021, possibly due to S59 (Islamic Finance News, 2021b). According to the interviewees, with the implementation of S59, the UAE issuers are actually having a very tough situation. The non-UAE issuers still have the choice of whether to comply with S59, though it is highly unfavourable for them to comply with S59, as we have discussed above. The UAE issuers must either adopt S59 or cancel their plan to issue sukuk.

As mentioned before, the HSA of the UAE's CB has made it compulsory for all Islamic financial institutions in the UAE to adopt AAOIFI Shari'ah Standards in 2018 (Saba and Barbuscia, 2021; Deloitte, 2018). The adoption also requires the existing products and services to comply with AAOIFI standards (AAOIFI, 2020).

In the context of S59, all IFIs under the UAE jurisdiction have to adopt S59 if they intend to structure, arrange or issue a sukuk for themselves or on behalf of their clients (for investment banks). It means the potential issuers in the UAE still have to comply with S59 because they have to appoint the UAE Islamic banks to become their advisors to issue a sukuk. An interviewee confirms this.

This situation is undoubtedly a challenge for the UAE issuers, proven by the recent data from S&P Global Ratings. S&P Global Rating reported that sukuk issuance volumes dropped 64% in the United Arab Emirates (UAE) for the year 2021, in part because of the additional complexity introduced by S59. The change has negatively affected the sukuk issuance appetite from issuers and investors (S&P Global Ratings, 2022). Based on the following Figure 3, it is evident that while other leading global sukuk players had positive or minimal negative growth in sukuk issuances in 2021, the UAE experienced significant negative growth in sukuk issuances in 2021.

Figure 3: Sukuk issuance volume in 2020 and 2021



Source: S&P Global Ratings (2022)

Thus, it is a deadlock situation for the UAE issuers, as they have to comply with S59, they may have difficulty marketing their sukuk outside of the UAE because most investors may not have the appetite for sukuk that comply with S59 due to various reasons that will be discussed in a separate paper.

The above also shows that, besides the S59 issue, the UAE market has to face the uncertainty of regulatory implementation. By virtue of the HSA's direction, all newly issued AAOIFI Shari'ah standards will be adopted in the UAE regardless of the market environment or the suitability of the standards with the market condition and practices.

Challenge No. 7: Incorporating the delisting event

Incorporating the delisting event would be the most challenging requirement for the issuers, as reiterated and explained at length by many interviewees. Fitch Ratings observed additional dissolution triggers in new international sukuk documentation, including tangibility, delisting events, and new put options. Such triggers may affect the liquidity, credit profile, and ratings of mainly non-sovereign issuers (Fitch Ratings, 2022).

The delisting event itself is not a Shari'ah requirement, as it is only a measure to ensure that the *Bay' al-Dayn* rules are followed when the sukuk is traded. However, the interviewees explained the reality of listed sukuk. When a sukuk is listed, the sukuk is not actually traded over the exchange. They are listed on the exchange for profiling and transparency purposes only.

The Luxembourg Stock Exchange, a popular exchange for listing sukuk, states the following advantages of listing a bond/sukuk on their exchange (Luxembourg Stock Exchange, 2022):

1. Greater visibility: Issuers benefit from greater visibility and enhanced brand recognition
2. More transparency: Boost investor confidence by generating more transparency for the issuance
3. Broader reach: Enable buyers bound by rules on unlisted securities to access the products

As for Bursa Malaysia, they mentioned that by disclosing information to the Exchange and the general public, the listed sukuk and debt securities would be more visible and transparent. The listing may help establish the issuers' profiles. As a result, a larger group of institutional and high-net-worth investors will be attracted to invest in the securities (Bursa Malaysia, n.d.). Note that the exchanges only talk about transparency and visibility but never about sukuk trading.

The point is, contrary to listed shares, listed sukuk or bonds are not traded at the exchange and are traded over the counter only. Over-the-counter transactions are conducted according to the terms and agreements of the parties involved. There is no control to prevent the parties from trading the sukuk or any securities at any price. Securities trading between two counterparties is performed outside of formal exchanges and without the supervision of an exchange regulator.

Therefore, there is no point in requiring delisting a sukuk. According to the interviewees, the delisting event is harmful and restrictive without achieving the intended objectives. Therefore, S59 does not solve the tradability issue except by preventing investors from holding their instruments and the issuers from keeping their sukuk healthy in the market. This requirement is very restrictive for the sukuk market.

Furthermore, the interviewees mentioned that the impact of the delisting event on the issuers could go beyond the delisting event itself. It causes an adverse effect or bad connotation on the issuers if the delisting event materializes in the future (none has happened so far). If the same issuer wants to reissue a sukuk in the future, it will be much harder for them due to the history of delisting events. An interviewee even compared a delisted sukuk facing the same scepticism towards sukuk default cases such as Dana Gas and Garuda Indonesia.

The above requires more explanation, and there are also other additional negative impacts of incorporating a delisting clause. Therefore, discussing the matter in a separate paper with more detailed analysis would be more appropriate.

8. Conclusion

The discussion above shows that issuers face too many challenges with the implementation of S59. Given all the challenges, it is natural for agnostic issuers to turn their interest away from the sukuk market. The regulators and relevant authoritative bodies must consider the issuers' concerns.

Implementing any standard should consider the interest of the stakeholders, especially those who have to comply with the standard. We are not in a position to be strict with additional strict requirements that could potentially disrupt the sukuk supply. Perhaps the following fact will justify why we must immediately fix this situation.

Global bond market outstanding stands at USD126.6 trillion as of 2021 (Securities Industry and Financial Markets Association, 2022), whereas global sukuk outstanding only stands at USD 732.10 billion as of 2021 (International Islamic Financial Market, 2022). That is a meagre 0.58% of the total global bond market outstanding, not even one percent.

As mentioned, this paper focuses on the challenges faced by the issuers. There are also challenges faced by the investors and the negative impacts of S59 on the market. They will be discussed in separate papers.

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