

## **Issue of Sukuk Market Development and Islamic Banking Institution: A Conceptual Paper**

Siti Nurulhuda Ibrahim, Amirudin Mohd Nor, Nor Shahrina Mohd Rafien, Shafinar Ismail & Nur Hayati Abd Rahman

Faculty of Business and Management, Universiti Teknologi MARA, Cawangan Melaka, Kampus Bandaraya Melaka, 75300 Melaka

Email: sitinur304@uitm.edu.my

### **Abstract**

Expanding the sukuk market and banking sector is essential to spur economic growth. However, these two components of financing providers do not cooperate fairly as a well-developed of one market is a drawback to another market. Hence, this study aims to highlight the issues encountered in developing one market that could threaten the expansion of other markets as capital providers to deficit units in the financial market. This paper is conceptual and exploratory in nature, and thus, it is supported by library research in an attempt to achieve the specified objective. Further empirical research can provide a better understanding and knowledge, and the issue that arises from this paper can be used as a future reference to understand the relationship between these two markets. Throughout the discussion of this issue, the policymaker will be aware and could construct a conclusive policy that is able to improve the sukuk market alongside the Islamic banking institutions while strengthening the financial market stability. This paper also offers insight into the development of the sukuk market and Islamic banking performance, which is relatively unknown to academics and Islamic finance industry practitioners.

**Keywords:** Sukuk Market Development, Islamic Banking, Conventional Banking, Banking Performance and Economic Growth.

### **Introduction**

Sukuk literally means a certificate, understood as an Islamic bond which is an innovation of Islamic finance and a shari'ah-compliant Islamic financial instrument to raise a fund in the market. The development of the sukuk market has been flourishing in recent years and still maintained its positive growth by becoming the main driving force in the industry through 2021 (IIFM, 2022). Sukuk issues recorded about USD 188.12 billion in 2021, 7.72% higher than a year before, even though the global economic outlook showed signs of inflationary pressures and a sharp rise in commodity prices, including oil.

Furthermore, sukuk continued to receive most public attention from corporates, sovereigns, and financial institutions as an alternative to raising and expanding funds, with greater emphasis on environmental, social, and governance (ESG) related issuances. In the case of financial institutions, the issuances were to support their liquidity management or, in some

cases, investment requirements (IIFM, 2022). However, despite this encouraging development of sukuk, compared to research on Islamic banking and Shari'ah-compliant stocks, the empirical research on the relationship between sukuk and Islamic banks is relatively limited and thinly in the literature. Indeed, banking performance and its determinants are extensively covered in Islamic banking research, while the study on sukuk is scattered over various issues. Therefore, studying the correlation between both markets has become the subject of increasing empirical inquiries. In fact, the Islamic banking and sukuk markets are very significant to economic growth.

On the other hand, the linkages between the banking sector and economic growth have been studied intensively. Meanwhile, there is a lack of studies that consider the impact of the sukuk market on economic growth (Tan and Shafi, 2021). Despite the fact that the expansion of the sukuk market provides an essential role in stimulating economic growth, however, based on empirical studies, its presence also seems to discourage some relevant components of the financial market, specifically the banking institutions. In this case, working towards developing Sukuk markets, which ultimately aims to boost economic growth, might result in banks becoming less performed, which could jeopardise the financial stability of the whole system. Unlike the bond market, which was found to complement the conventional banks and the sukuk market development while unaffected the Islamic banks, sukuk was discovered to substitute the Islamic banks and did not affect the performance of conventional banks (Smaoui and Ghouma, 2020; Smaoui et al., 2020; Mimouni et al., 2019). In some cases, Islamic banks will naturally oppose the development of Sukuk markets (Smaoui et al., 2017). At this juncture, the substitution effects between the two markets do not augur well for the country's economic development.

This paper will first contribute to the literature by expanding the knowledge of the factor that can influence the Islamic banking sector and also calls for attention to their relationship in contributing to economic growth. Secondly, this paper opens a new avenue for future researchers to investigate further the interaction between the sukuk markets and the Islamic banks, as the empirical studies on their relationship are still limited and raise a current debate among scholars on whether demonstrated as complementarity or competition sectors. Lastly, this paper is expected to give regulators or policymakers an awareness regarding the interaction between these two sectors in maintaining sustainability in financial market development.

### **Concept of Financial Market Development with Economic Growth**

Financial market development can be defined as the factors, policies, and institutions that lead to efficient intermediation and effective financial markets. It improves the competence of the financial market to perform efficiently as an intermediary to stimulate economic growth and reduce poverty (Alomari et al., 2019). A healthy financial market consisting of banks, bond markets, and equity markets, conventional and Islamic, is vital in stimulating economic growth. Thus, the stability of financial markets is crucial in producing strong economic growth as they contribute to economic efficiency (Durusu-Ciftci et al., 2017). Pagano (1993) suggests three ways in which the development of the financial sector might affect economic growth under the basic endogenous growth model. First, it can increase the productivity of investments. Second, an efficient financial sector reduces transaction costs and thus increases the share of savings channelled into productive investments. An efficient financial sector improves the liquidity of investments. Third, financial sector development can either promote or decline savings. The financial sector acts as a lubricant for the economy,

ensuring a smoother allocation of resources and the emergence of innovative firms (Creel et al., 2015). Thus, economic growth will be accelerated by fostering the development of a country's financial sector (Durusu-Ciftci et al., 2017).

Meanwhile, the role of financial development on economic growth has received considerable attention at the empirical level study. Most empirical models generally indicate that well-developed financial markets enhance the efficiency of resource allocation and faster long-run growth via several channels. Several studies examine the simultaneous impact of both markets on growth. According to Khoutem (2014), a well-functioning financial system directly promotes a country's economic growth. But this relationship also might vary on different levels of economic development and other countries' specific factors. In addition, Beck and Levine (2004) show that both stock markets and banks positively influence economic growth, and the contribution of the credit markets is substantially more enormous.

### **Concept of Sukuk Market Development with Economic Growth**

Sukuk market expansion benefits the government as government budgets cannot be the only source of financing to fund such a long-term project. Massive financing is required for economic development, particularly for emerging and developing economies, as to support infrastructure and industrialisation in the country. According to Khoutem (2014), sukuk positively affects sustainable economic development. He addressed three conclusions on how sukuk can stimulate economic growth; firstly, sukuk can help to establish an efficient Islamic capital market and strengthen the value-added of Islamic finance to economic growth. Secondly, sukuk is a growing instrument to mobilise and raise public and private funds. Lastly, sukuk offers an important opportunity to finance development projects since it may act as a long-term financing tool to fund a potential infrastructure, agriculture, and industry project. His opinion is supported by (Smaoui and Nechi, 2017; Yildirim et al., 2020).

Smaoui and Nechi (2017) argued that domestic sukuk market development contributes to the country's economic growth in many ways for reasons: First, sukuk markets mobilising savings, make financing available for long-term debtors, thereby contributing to the efficient functioning of capital markets. Since long-term funding is crucial to the economy's productivity gains, this role of capital rationing is of significant importance to the finance-growth link. Second, sukuk markets, along with bond and stock markets, contribute to the deepening of the financial market of an economy. For instance, in the absence of sukuk markets, banks tend to have reduced opportunities for investing in deposits, and that may lead them to make unsound or suboptimal loans. A well-functioning sukuk market allows banks to invest in sukuk certificates and hence mitigate information asymmetries, thus fostering the efficient allocation of resources essential for economic growth. Third, a well-developed sukuk market coupled with an advanced financial structure may stimulate economic growth through technological innovations and enhanced labour productivity in the private sector. Fourth, sukuk certificates are based on risk-sharing, meaning that the issuer and the investor share the risk of the investment and split the profits or losses between them into agreed terms. This risk-sharing feature of sukuk will lead borrowers and lenders to share business risks in return for a share of benefits, which may spur investment and economic growth. Finally, sukuk securities can drain the savings of Muslims who are not willing to invest in interest-based bonds since they carry *riba* (interest) prohibited by Sharia principles. Thus, it could stimulate investment and economic growth. In the absence of sukuk certificates,

savings would not be used efficiently and, therefore, not channelled to the formal financial sector, which may hinder investment and economic growth.

Meanwhile, Yildirim et al (2020) revealed that a long-term cointegrated relationship exists between sukuk market development and economic growth. Sukuk volume and sukuk density positively affect growth in the long run. At the same time, sukuk did not affect growth in short-term relationships. Therefore, the sukuk market development will positively expand the Islamic finance industry as well as economic development in the long run.

### **Concept of Islamic Banking Institution with Economic Growth**

The banking sector is essential for economic development and growth. However, although Islamic banks achieved tremendous growth in the past decades, conventional banks have shown some deficiencies in recent financial crises (Yildirim et al., 2020). In this fact, the Islamic banking system, considered an alternative model, has entered the banking sector of many countries (Cevik and Bugan, 2018).

Many studies produced evidence that the banking sector development is positively and strongly correlated with long-run economic growth (Levine, 1998; Levine and Zervos, 1998; Rousseau and Wachtel, 2000; Cole et al., 2008; Creel et al., 2015). However, according to Narayan and Narayan (2013), to generalise that banking sector development stimulates economic growth in both developed and developing countries can be misleading because the positive relationship may be driven only by the developed markets.

On the other hand, the banking sector can contribute to economic growth depending on the stability or otherwise of the sector (Rizvi et al., 2019). The studies of Imam and Kopdar (2016); Creel et al (2015); Pradhan et al (2015); Wolde-Rufael (2009); Levine (2005), among others, also indicated the same results where they conclude that without a stable banking sector facilitating capital flows, sustainable economic growth will become challenging. Furthermore, according to Rizvi et al (2019), any progress and innovations in the banking sector, such as the emergence of Islamic banking, leading to a dual (both Islamic and conventional) banking system, will have implications for the stability or otherwise of the banking sector. Regarding their findings, the presence of Islamic banks in the Indonesian banking industry adds to the banking system's stability, although it does not affect profitability.

Meanwhile, Islamic banks are contributing to the expansion of economic activity by efficiently managing financing and investment activities, enabling them to give out funds better to highly viable firms. According to Khoutem (2014), Islamic banks help to overcome asymmetric information in direct financing through monitoring and screening since they have direct access to corporate financial information. Besides, Islamic banks also identify potential investment opportunities by evaluating risk management and controlling the risk through diversification.

### **Concept Sukuk Market Development with Islamic Banking Institution**

In general, integrating the sukuk market and Islamic banks can overcome many problems related to banks' liquidity management, long-run investment, financing cost and saving mobilisation challenges. For instance, in the case of Islamic banks' assets and liabilities, according to Khoutem (2014), the bank can mobilise resources through bank savings and market savings. In addition, sukuk has captivated in sustaining bank growth and maintaining healthy capital adequacy levels (Mimoui et al., 2019).

Subsequently, Khan (2011) asserted that banks could access additional capital as sukuk issuers and solve the problem of unused Islamic funds as an investor, which is able to stimulate the accumulation of funds and strengthens the prospects of Islamic banks as contributors to economic development. Instead of bringing benefits to both parties, the sukuk market and banks still suffer from many obstacles that may hinder the contribution to economic development, such as the dominance of asset-based sukuk and the lack of an efficient secondary sukuk market (Smaoui and Ghouma, 2020; Khoutem; 2014)

Meanwhile, in empirical works, Smaoui and Ghouma (2020) highlighted that there are limited studies on the sukuk and the Islamic banking sector. Besides, according to Smaoui and Ghouma (2020); Mimouni et al (2019); Smaoui et al (2017), there is a significant and negative relationship between the sukuk and Islamic banking sectors and vice versa. They found both sectors are substitutes.

### **The issue of the development of the sukuk market toward the performance of Islamic banks**

It is acknowledged worldwide that a well-functioning financial system contributes directly to a country's economic growth. Meanwhile, even though banking institutions, bonds, sukuk, and the stock market can boost economic growth, according to previous research, if Islamic banking institutions are more prominent in the market, it will deprive sukuk market development and vice versa.

In line with that, Mimouni et al (2019) conducted the study by employing bank profitability as the independent variable, with other independent variables consisting of six variables: capital ratio, asset quality, management efficiency, liquidity risk, size, and overall riskiness. The result revealed the whole sample, where Sukuk issuances harm banks' performance measured using the Net Interest Margin (henceforth NIM) or net profit margin (henceforth NPM). Besides, the result confirmed that sukuk issuance and the Islamic banking system are substitutes. Moreover, according to the most recent study by Smaoui & Ghouma (2020), there is no doubt that countries are trying to develop their financial markets but also aspire to strengthen their banking systems to improve their resilience to shocks. However, based on their findings, these two objectives might not always move alongside where both sectors are substitutes. Still, the researchers did not further study in detail on that the relationship. Thus, this leads to our objective of this paper to raise the issue of this association. It certainly opens a new promising avenue for future research to go further and provide detailed answers to these issues.

Following the above empirical findings, surprisingly, some subsequent studies also unveiled the same conclusion. According to Smaoui et al (2020), if the government works toward developing Sukuk markets, which ultimately aims to boost economic growth, it might result in Islamic banks becoming less performed in terms of increasing the insolvency risk and drawing away profits and decapitalised, which could threaten the financial stability of the whole system. On the other hand, a well-developed Islamic banking sector hinders the developing Sukuk markets, which concluded that sukuk and bank financing are substitutes (Smaoui et al., 2017).

These empirical studies so far revealed that their research does not answer many questions on how this might happen or why it does. Therefore, how can a sustainable Islamic financial market be developed since both the sukuk market and Islamic banks cannot move alongside? And according to Hassan and Chaci (2005), the Islamic financial institution could help balance allocative efficiency and distributional equity. Furthermore, a well-developed sukuk market would provide banking institutions, especially Islamic banks, with various sukuk issuances as

an opportunity to invest in high-quality sukuk and as a platform to obtain valuable long-term financing prospects (Smaoui and Ghouma, 2020). Therefore, due to this potential liquidity and stability, it should be considered in the development policy, and former strategies should be revisited with a particular emphasis on wealth democratisation.

Meanwhile, according to Khoutem (2014), numerous studies asserted a positive and systematic impact of conventional financial development on economic growth. Empirically, there is a complementary relationship between bond market development and conventional banking institutions, but the former does not affect the performance of Islamic banking. On the other hand, as abovementioned, sukuk market development adversely affects the performance of Islamic banks, while conventional banks remain unaffected (Smaoui and Ghouma, 2020; Smaoui et al., 2020; Mimouni et al., 2019). Some questions might arise from this scenario; why can the bond market and conventional banking complement each other while sukuk market development rivals Islamic banking institutions? It means that the Islamic banks will naturally oppose the expansion of Sukuk markets as they will become a handicap if this Islamic capital market emerges. Thus, this puzzling issue becomes the gap to be solved. Concerning these limitations, it is essential to investigate this issue further and create a conceptual framework that could stimulate Islamic financial development (i.e., Islamic banking institutions and the sukuk market) to spur economic growth. Further study will benefit the decision-makers, regulators, practitioners, and academicians.

### **Conclusion**

Although the development of sukuk markets and Islamic banking plays a vital role in stimulating long-run economic growth, each of their existence seems to discourage expansion and thus may hinder financial stability. Understanding such tricky developments between sukuk market development and Islamic banking institutions is essential to create sustainable economic growth. In the future, empirical research should be carried out immediately to investigate why the development of the sukuk market is a hindrance to the Islamic banking institution and vice versa. Furthermore, to add more to what has been documented, future researchers probably need to consider how the sukuk market development is defined. The study should also focus on different Islamic banking sector development perspectives to see the impact. Moreover, the detailed research should investigate the impact from different aspects, including types of sukuk issued, economic periods or various Islamic banks' characteristics. These characteristics comprise the banks' size, leverage, liquidity and risk level, age, moratorium support, and others to examine if the impact will differ. Identifying the main factor that contributed to the relationship will be beneficial. Overall, this academic effort significantly enhances our knowledge of Islamic finance and outlines the specific future research agenda.

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