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The Role of Political Risk and Financial Development Factors on Sukuk Market Development of Gulf Cooperation Council (GCC) Countries

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Abstract

The literature related to the financial management acknowledges the significant role that political risk play to determine the financial market development. Further, financial system development (banking and financial markets) competes to provide long-term financing, and this competition might be positive or negative for each other. The aim of this paper is to propose a conceptual model/framework for investigating the role of political risk and financial market on Sukuk market development in Gulf Cooperation Council (GCC). GCC economies depend heavily on oil revenues which makes them subject to oil prices fluctuations. Therefore, GCC's governments should diversify their economies by looking for Sukuk as an alternative source of financing, to cover their budget deficit, when the price of oil decreases, and reduce their reliance on oil, because Sukuk has advantages compared to the conventional bond particularly in terms of less information asymmetry. The prior studies have mostly focused on firms' characteristics determinants of Sukuk issuances but gave a little consideration to the role of country' characteristics on Sukuk market development. This paper proposes a framework to explain the political risk and financial markets determinants of Sukuk market development with a focus on the GCC countries that have the largest region in terms of the Islamic financial assets. It is anticipated that the outcome will support policymakers to improve the current state of Sukuk market.

Keywords: Sukuk, political risk, financial market, GCC

1. Introduction

Several types of research have been carried out on the determinants of the development of capital market including both equity and debt market. Hence, the determinants of the stock and bond market development were the subject of major theoretical and empirical studies in both developed and developing countries from the different perspective. On the contrary, the growing importance of Sukuk markets around the world has recently opened a new avenue of research into the challenges and factors which the development of Sukuk market is facing. Nevertheless, there is relatively a very limited amount of literature focusing on Sukuk market. Though, this paper has not found any study on the role of political risk and financial market variables on Sukuk market development in GCC countries.

Sukuk market is important to contemporary Islamic economies. This is because it plays the role of a mediator between lenders and borrowers. Thus, Sukuk market might play a key role in economic development and support the gross domestic product (GDP) of countries. This can be done through the mobilization of savings and by channelling these savings to useful and Islamic law compliant investments. Several businesses and policymakers are viewing at the Sukuk markets as a long-term financing source. Since they are a mechanism of financing for the long-term and thanks to their investment diversification, they can finance potential projects in industry infrastructure, and agriculture (Tariq & Dar, 2007).

Kusuma and Silva (2014) argued that as many countries tried to establish sources of long-term financing, Sukuk appears to be the most relevant way of assisting such countries, expand the pool of capital for investment's financing and reinforce growth. Thomas (2007) further claimed that there is a huge potential for Sukuk whose growth is largely dependent on the Gulf Cooperation Council's (GCC) and Asia's strong economic base. Sukuk as significant players of Islamic financial market operate in an external business environment, which is an interdependence of several factors related to a society that form and determine their activities. The external business environment is comprised of political, environmental, social, macroeconomic, financial, legal, and technological factors that impact and form the financial markets and institution's activities. Sukuk issuances are determined by these external business environment determinants which externally impact the financial strategies of corporations, including debt funding decisions.

Several countries are completely involved in efforts aimed at developing their domestic Sukuk markets, but with diverse levels of success recorded to date. Shahida and Sapiyi (2013) highlighted that identifying the factors that determine the issuance of Sukuk be it based on internal or by external incentives are noteworthy. Accordingly, Kusuma and Silva (2014) pointed out that the current approaches adopted for the development of the domestic Sukuk market vary significantly across countries, due to country-specific circumstances. Furthermore, Samoui and Khowaja (2016) noted that countries trying for the promotion of their Sukuk markets should foster the development of their institutions of governance by fighting corruption in the political system and improving the local investment environment to create an attraction for investors to hold Sukuk securities.

GCC region has long been an unstable and constantly changing region, but the U.S. invasion of Iraq in 2003, the region wide upheavals that began in 2011, the Yemeni civil war that began in 2013, and the massive drop in petroleum prices and revenues that accelerated in 2015 have combined to increase risk at every level. These uncertainty associated with an unstable political environment may reduce investment and the pace of economic development. While the weakening in oil prices may have an adverse impact on Islamic capital markets, the indicators shows that so as to overcome the budget deficit the GCC countries may opt for sukuk in bringing their infrastructural development which is expected to provide further impetus for the expansion of the Islamic capital market (Ayturk, Asutay&Aksak, 2017).Further, Chau et al. (2014) investigated the influence of political uncertainty instigated by the current civil uprisings on the volatility and integration of conventional and Islamic stock market indices in the MENA region of the Arab World. The findings show significantly rising volatility in Islamic indices over the political turbulence period, while there is a little or insignificant influence of uprising on the volatility of conventional markets. The effect however has spread to other countries in the same region including the wealthy countries in the GCC who should be less affected by Arab Spring.Therefore, the impacts of political risk on sukuk market still ambiguous.

Furthermore, The GCC region can be characterized as one of the largest Islamic banking markets in the world, and its huge supply of savings and strong investment demand might be generally furnished through its banking system. This results in total dependence on the banking system rather than the Sukuk market. Therefore, whether the credit market is bank-oriented should have a bearing on Sukuk. Further, banks and sukuk markets compete in providing finance, and well-developed banking systems can deprive sukuks of market share.Further, Nagano (2010) found that issuance of the Sukuk improves the stock returns of the issuers and total factor productivity, and this empirical finding recommends that preference is given to Islamic bond issuance due to this exclusive benefit that standard external finance is unable to provide. Thus, to uncover how this factor affects Sukuk markets, the further empirical investigation becomes necessary.

The tendency of recent studies is to focus on the firms' characteristics and their impact on the choice decisions of bond or Sukuk issuance in the firm's finance structure. However, the influence of political risk and financial development factors on Sukuk market development has remained vague and not fully understood because of lack of the studies. This paper tries to fill the gap by offering a model that can be utilized to explain this research issue and makes an addition to the literature through explaining the relationship between political risk and financial development variables and Sukuk market development in GCC countries.

The paper proceeds as follows: Section 2 concentrates on the "Sukuk". Section 3 discusses various literature related to political risk and financial market and sukuk market development. Section 4 offers the expected policy implications. Section 5 offers some conclusions.

2. What Is Sukuk?

Sukuk (plural of sakk) are explained as Islamic bonds, literarily denote Islamic type of investment certificates that are likened to conventional bonds. Issuances of Sukuk and Islamic banking are two of the most famous and broadly accepted *Shariah*-compliant practices in the industry of Islamic finance where Islamic banks are considered as conventional bank's counterparts and Sukuk offers the *Shariah*-compliant type of conventional bonds. Sukuk, usually recognized as Islamic bonds, is an investment certificate which follows Islamic law. AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) (2010) describes Sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or the assets of particular projects or special investment activity".

Further, Godlewski, Turk-Ariss and Weill (2013) opined that Sukuk is investment certificates that are characteristic of both bond and stock-like features that are allotted for financing trade activities or in producing tangible assets. Contrarily, as compared to conventional bonds, the Sukuk do not offer guaranteed returns and cash flows; there is no interest payment, as returns on Sukuk are associated with the profit generation that is achieved by real transactions from an underlying real business risk (Zakaria, Azwan, Isa, Alawiyah, &Abidin, 2012). This striking disparity among Islamic and conventional financial tools provides a contribution to comparatively positive performance of Islamic finance during and post global financial crisis 2008.

Sukuk (Islamic bond) and conventional bonds are similar in purpose and both are used for long-term financing. As noted by Ahmad and Radzi (2011) and Saad, Haniff and Ali (2016), in some respects, the Sukuk is like the conventional bonds, it is a security instrument that offers an expected return's level. Though, the fundamental structure and provisions of the Sukuk are dissimilar. In that a bond is a representation of the actual debt of the issuer, the Sukuk is a representation of certificates of equivalent value with undivided beneficial (proportional to the investor's participation) ownership in the underlying assets, usufruct, services or investment in certain projects or activities of special investment. Contrary to this, Conventional bonds can be classified as either pure debt contracts or represent financial claims on opaque projects where the underlying asset may not have a real economic value.

3. Review of the Related Literature

Despite the emergence of Sukuk across different markets worldwide, there are few studies on this subject. Consequently, in what follows, it is worth assessing the literature on the political risk and financial determinants of conventional bond markets.

3.1 Overview of GCCs' Sukuk Market Development

The development of Sukuk market in GCC countries has undergone through three distinct stages. The first stage from 2001 to 2007 which coincided with the oil boom and rapid development of the global market; around 41% of the total Sukuk issuances so far were within this period, and only 27% of the total Sukuk issuances so far were in the second stage 2008 to 2010 which was low because of the global financial crisis. The third stage started from 2011 and continues to date. The best time was since 2001 in terms of Sukuk issuance in GCC countries, as the number of issuances was 60 in 2012, which was the highest issuances obtained in GCC countries. The issuing value reached a new record, which broke the records of 2007 with a big margin. The beginning of the year 2013 was good for the GCC Sukuk market as the number of issuances was 18 within only three months. Evidently, Bahrain was the first issuer of Sukuk and the Central Bank of Bahrain (CBB) issued Salam and Ijarah Sukuk are typically oversubscribed. However, the UAE issues the highest number of Sukuk in terms of volume, making it the leader in GCC region, while Bahrain is leading in terms of number of issues in Sukuk market.

The concept of financial market development (both equity and debt) has many dimensions. As evident in literatures, there are three eminent indicators of stock market development, namely, market capitalization, trade ratio and turnover ratio. While the first indicator is usually used to measure the size of the stock market, the last two indicators are commonly used to measure the liquidity of the stock market.However, extant empirical underpinnings support the use of market capitalization as proxy for the development of the bond market.The notion behind this measure is that the complete market size is positively correlated with the ability to mobilize capital and diversify risk in an economy (Yartey, 2008).For the above reason, the choice of the measurement of Sukuk market development is based on the models for estimation and the data availability. Regarding Sukuk market, this study suggests adopt the direction taken by previous studies(Smaoui & Khawaja, 2016; Said & Grassa, 2013) and utilizes the total value of Sukuk issuances as percentage of GDP as proxy for Sukuk market development.

According to Thomson Reuters Report (2016), there has been deterioration in the percentage of GCC's total Sukuk issuance in the recent years. The GCC's share of global Sukuk issuances decreased in the recent years, where the volume of Sukuk issuances in the GCC continued to fall since 2013, while the volume of bond financing increased. Table 1 presents the descriptive statistics of Sukuk market development (SMD) across GCC countries; named Saudi Arabia, United Arab Emirates, Bahrain, Qatar, and Kuwait; over the period 2001 to 2016. This analysis excludes the country of Oman from the analysis because the capital market authority of Oman started the process of Sukuk issuance recently in October 2012.

Table 1. Descriptive Statistics of Sukuk Market Development (SMD) by Countries over 2001-2016

Country	N	Min.	Max.	Mean	Standard Deviation
Saudi Arabia	16	0	.0137364	.0038345	.0039324
United Arab Emirates	16	0	.008851	.0016253	.0083509
Bahrain	16	.027306	.1761255	.0917529	.0449971
Qatar	16	0	.0540362	.0078257	.0134053
Kuwait	16	0	.031756	.0036019	.0023473
All Countries	80	0	.1761255	.0217281	.0410029

Source of sukuk data: Bloomberg database

Table 1 shows that United Arab Emirates has the lowest level of Sukuk market development, which is about less than 1% with standard deviation 0.008 and varies from as low as 0 (no Sukuk issuance) to a maximum of 0.89%, while Bahrain has the highest level of Sukuk market development, which is about 9.17% with standard deviation 0.045 and ranges from a minimum of 2.73% to a maximum of 17.6% of GDP. Also, the percentage of Sukuk market volume relative to GDP for Kuwait and Saudi Arabia seems to be within the same level which is about less than 1% (0.36% and 0.38% respectively). The level of Sukuk market development in Qatar reported in this study is .78% and ranges from a minimum of 0 to a maximum of 5.4% of GDP. As it can be seen in Table 1, the total average of GCC's Sukuk market development is very small relative to GDP, which is 2.17% with a maximum value of 17.6% in Bahrain. This result is consistent with Grassa and Gazdar (2014), who found that the Sukuk market is new and normally small capital market in the GCC countries, thus GCC's Sukuk market do not approach the level of threshold that enables them to contribute towards economic growth.

Based on the above discussion, it becomes imperative to conduct this study as an initial attempt to explore the factors affecting the Sukuk market development in the GCC countries as these factors being overlooked by previous researchers.

3.2 Political and financial variables and sukuk market

It is apparent that there is a scarcity of literature associated with the Sukuk markets at country level, but, in particular, there is also a lack with regard to the GCC's Sukuk market. Actually, the empirical literature reviewed in this paper, two studies only include the Sukuk market development and analyzed the influence of foreign factors on its dynamic behavior. These two studies conducted by Smaoui and Khawaja (2016) and Said and Grassa (2013), are very similar, which only focused on some macroeconomic and financial factors over the same period for 13 countries from different regions. Hence, the further empirical investigation becomes necessary. Therefore, the current literature reveals research gaps about the factors of Sukuk market development in GCC countries, as shown in the Figure 1.

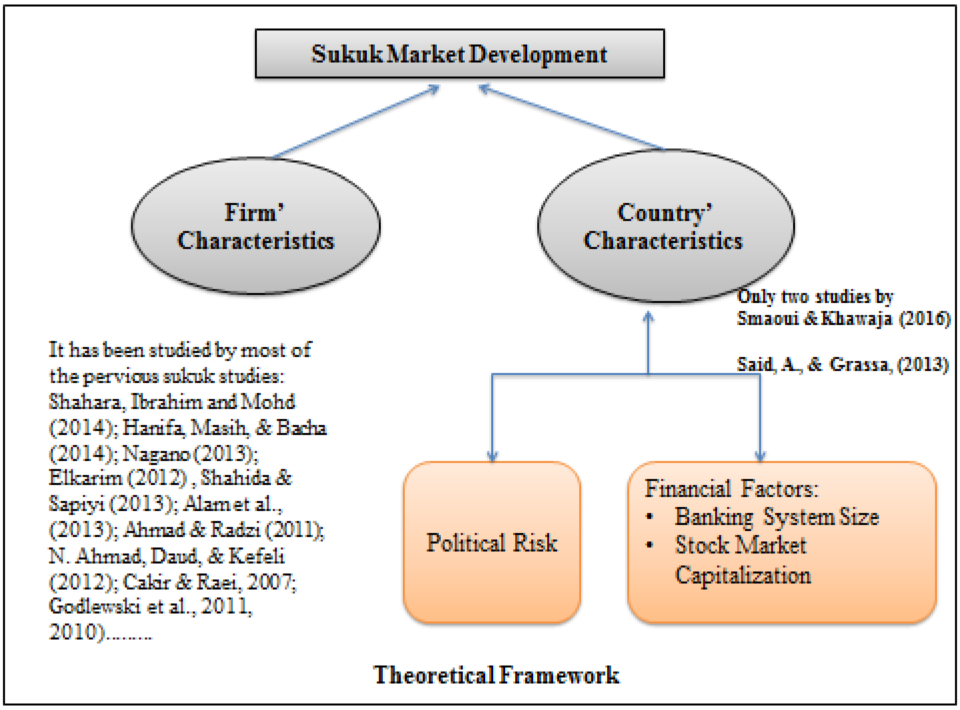

Figure 1. Theoretical Framework

3.2.1 Political risk and sukuk market development

This is an important factor that has played a role in determining bond market development over the years and the majority of the researchers have determined a significant association among political risk and bond market development.Majority of the results tend to be significant and negative on the market of stock and bond (Kim & Mei, 2001; Roubini, 1991; Cherif&Gazdar, 2010; Garcia & Liu, 1999a; Yartey, 2008, 2010)

Economics has a permanent relationship with politics. According to Yartey (2010), the political risk is one of the most important risks facing investors when they decide to invest in emerging markets. Political risk indicates the financial risk if a government suddenly changes its policies. Economic growth is affected by political risk. This type of risk has direct consequences for the income level by ruining the productive capacity and does not support for the creation of business environment essential for any economy to flourish. The resolution of political risk can enhance confidence of the investor and boost the progress of the bond markets in emerging economies (Cherif and Gazdar, 2010). With political instability, the risk of a capital loss will tend to increase, chiefly due to political and economic rules governing investments are expected to vary with political regimes and thus create volatility in macroeconomic indicators, rising the uncertainty in future net returns and, hence, lowering expected real rates of returns linked with investment projects.

Akkaş (2017) states that, in particular, since the Arab Spring, GCC countries have tried to invest in Islamic finance through government investment, for example their own sovereign wealth fund, with the intention of development of their domestic economies. According to standard and poor credit analyst, events such as the worsening relationship between Saudi Arabia and Iran playing out in Bahrain, Iraq, Lebanon, Qatar, Syria, and Yemen, corruption allegations against ministers and prominent business figures in Saudi Arabia, and the continuing trade restriction of Qatar, which caused suffer rating downgrades. This rating downgrade is also forcing some GCC countries to diversify funding sources and widen their sukuk market.

When political risk increases, uncertainty about the future polices of the government also tend to rise, resulting in increasing information asymmetry problems, and adverse selection and moral hazard in the financial market; this in turn leads to great swings in investment and financing decisions. Nagano (2017) found that firms with a high degree of information asymmetry prefer sukuk to equity and debt issuance. Firms with greater information asymmetry are more likely to issue sukuk than bonds because sukuk leads to a less efficient monitoring of shareholders and management than does bonds (Klein and Weill, 2016). Consequently, sukuk is an appropriate investment and financing tool as it overcomes information asymmetry problems, because in the worst case there are assets which contain sukuk structures. Further, Roubini (1991) found that an increase in the degree of political instability appears to lead to greater budget deficits. Therefore, increase in political risk lead to greater budget deficits, increased credit risk and increased expected costs of debt and equity, thereby expanding the sukuk market to finance these deficits. However, the influence of political risk on sukuk market still ambiguous and hence the further empirical investigation becomes necessary.

To the authors' knowledge, the influenceof political risk on sukuk market development not exists in the previous studies. Hence, the further empirical investigation becomes necessary. For this paper, we suggest adopt the direction taken by previous studies (Al-Jaifi, 2016; Cherif&Gazdar, 2010; El-Wassal, 2005; Erb, Harvey, &Viskanta, 1996; Gelos, Sahay, &Sandleris, 2004) and utilizes the political risk index of ICRG, a composite index provided by the International Country Risk Guide (ICRG) as a measure of political risk. The ICRG agency provides ratings which reflect the risk inherent in a country and are a reliable method of risk assessment. This index ranges from zero to 100 points, with 100 indicating the lowest risk and zero the highest (higher score, lowest risk). Change in this index will have an influence on the sukuk market.

3.2.2 Financial market variables and sukuk market development

3.2.2.1 Banking system size

Banking sector is an important participant in the economic development process.The banking system represents the largest part of the financial system in most countries, especially in developing and frontier market economies. Islamic banks and conventional institutional are the main investors in sukuk because the market is sufficiently large and relatively liquid. As well, sukuk are the only liquidity tool available for Islamic financial institutions in case of need of liquidity. Hence, the growth of Islamic financial assets will be associated with a growing need of liquidity, thus imply an increasing amount of issuance of sukuk by Islamic financial institutions and also commercial banks. According to Aziz (2007), and Kusuma and Silva (2014), another important aspect of the development of the sukuk market is the development of the other key components of the Islamic financial system, the money market, banking sector. Important implication of banks in the sukuk markets both as issuers and buyers. A large banking sector will help the government sell its debt and sukuk domestically. Therefore, in developing the sukuk markets, the presence of both Islamic and conventional banks as dealers and market makers is required.

Contrary to this, there is competition among banks and sukuk markets to provide finance, and a strong banking system can rob sukuk of its market share. Adelegan and Radzewicz-bak (2009) noted that countries with highly developed banking sectors show less dependence on bonds, resulting in a less developed bond market. Adelegan and Radzewicz-bak (2009), Bhattacharyay (2013), Nkwede, Uguru and Nkwegu (2016), and Raghavan and Sarwono (2012), the findings of all studies showed a significantly negative association among banking sector's size and development of bond market.

Concerning sukuk, Said and Grassa (2013) found that banking size have no significant effect on the issuances of sukuk.On the contrary, Smaoui et al., (2017) found Sukuk and bank financing are substitutes (negative) and economies where banks play a key role in providing private credit issue less Sukuk. Hence, the further empirical investigation becomes necessary.Following prior studies,for the proposed study this paper suggests the adoption of the total of domestic credit made available by the banking sector relative to GDP as a measure of banking system size.This ratio measures the role of financial institutions as a financial intermediary in providing long-term financing to the private sector and also used as an indicator of financial intermediary development. According to Yartey (2008), private credit captures the amount of external resources channeled through the banking sector to private firms. This measure isolates credit issued to the private sector in opposition to credit issued to public institutions.

3.2.2.2 Stock market capitalization

One incontrovertible fact about stock and sukuk is their existence in the same markets albeit with separate regulations relating to *Shariah* compliance. Actually, the market is driven forward by investor demand. Depending on the risk and return offered, the firm and investor take the decision to finance and invest in either or both sukuk and stock. When the capital market is established, the corporation's debt-financing level has a tendency to be lower for the reason that the broader supply of funds reduces the cost of equity. Therefore, the presence of the stock market can deprive sukuk of market share. On the other hand, well-functioning stock markets reduce asymmetric information and enhance corporate governance, lowering the cost of external equity and the cost of issuing debt (Demirgüç-Kunt&Maksimovic, 1996).

Nagano (2010) found that issuance of sukuk contributes to a rise in the stock returns of the issuer and total factor productivity, and these empirical finding recommends that issuance of the Islamic bond is given preference due to the reason that, the unique benefit which standard external financing is unable to offer. Furthermore, Ibrahim and Minai (2009) found that sukukissuance increases the issuers' share price. Further, Godlewski et al. (2011, 2013) argued that two hypothetical positions suggest a positive reaction of stock markets to sukuk issuances. First, sukuk issuance could probably send positive signals to markets. This is likely going to help solve the confrontational selection problem cause by asymmetrical information between players inside and outside the firm. Second, sukuk issuance is capable of reducing moral hazard behavior and agency costs occasioned by conflicts of interest between shareholders and managers.

Consequently, the sukuk market might substitute for or complement the stock market. Alam et al. (2013) stated that borrowers with the lowest return expectations will have an inducement to prefer sukuk. However, Smaoui et al., (2017) found strong positive significant between stock market capitalization and sukuk market development, hence it appears that stock market and sukuk market are complements rather than substitutes.Stock market capitalization is measured by the total value of all listed shares in a stock market as a percentage of GDP. The size of stock market in previous studies (Smaoui et al., 2017; Cherif&Gazdar, 2010; Colombage, 2009; La Porta et al., 1997; R.P. Pradhan et al., 2015; Roe & Siegel, 2011) is used to measure the stock market development.The notion behind this measure is that the complete market size is positively correlated with the ability to mobilize capital and diversify risk in an economy (Yartey, 2008).

4. Policy Implications

The policy implications will be based on the outcome of the proposed research on the role of political risk and financial market variables on Sukuk market development in GCC countries. If the empirical evidence establishes the political and financial factors influence the Sukuk market development then the policy implication will be for the governments, policymakers, investors, creditors and researchers, especially concerning issues relating to Sukuk market. It will be possible to make recommendations to support country's specific factors in the Sukuk market that are expected to contribute to the sustainable growth of Sukuk market with the findings. This proposed model will providesa well knowledge for external investors to recognize the political risk that affect sukuk market development in GCC so as to guide their investment decisions.

Furthermore, it will also be possible to provide recommendations regarding, which factors the management should give more weight in managing risks or minimize the negative effect and avoid unnecessary disappointments. The practice of good factors knowledge will definitely help to promote the growth of the Sukuk market. The findings of this study will help the investors and creditors to know that their interests will be protected from political risk with high investment in sukuk market rather than conventional markets, if the empirical evidence establishes that the political risk affect sukuk market differently of conventional market.The government should develop strategies for linking and integrating the banking sectors and sukuk market in order to promote sukuk market development.

5. Conclusions

In view of the ongoing global financial and economic crisis, low oil price and political instability, the development of Sukuk markets in GCC region assume high importance for financing the region's corporate and government sector and large demand for infrastructure. Well-developed Sukuk markets can provide GCC countries with alternative sources of financing and at the same time improve the region's financial resilience by balancing the high dependence on the oil exports and banking sector. Therefore, to enhance the Sukuk market, there is the need for GCC countries to understand the role of political risk and financial market factors on Sukuk market. This is essential to promote their Sukuk markets through develop strategies for linking and integrating the banking sectors and sukuk market, and improving the local investment environment to create an attraction for investors to hold Sukuk securities.

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