Chapter 39

Sukuk as an Infrastructure–Financing Tool

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ABSTRACT

Although many studies have stressed potential benefits of using Sukuk for funding large-scale infrastructure projects, several technical, legal, and political obstacles that are encountered by new sovereign and corporate issuers, investors, and Shari’ah boards remain largely unexplored. This research evaluates the opportunities, barriers, and potential risks for future Sukuk issuances that are proposed for funding large-scale infrastructure projects in developing countries. A purposive sampling method was employed to conduct in-depth interviews with several Islamic finance experts in support of the qualitative data analysis. Using the maximal variation and snowball approach, the researcher identifies the key challenges for large-scale Sukuk issuances and provides useful interpretations that can contribute to the expansion of Sukuk structures for a wider international investor base.

INTRODUCTION

Research Background

The world has rarely been more vulnerable to the vagaries of the modern economy than it is today. The proliferation of speculative and destabilising financial instruments led the conventional financial system to experience one of its worst crises since 1930. Although the globalization of financial markets seems to promise prosperity for a small number of distinctive economies which can insulate themselves against the consequences of financial contagion, the fragile nature of their underlying political structures and networks continue to spread misery among the poorer countries. Over the past three decades, Islamic finance has emerged as an alternative to the existing international financial order. This can be attributed to the fact that it is based on the principles of prohibiting interest, profit- and -loss sharing as well as participatory financing which combine the ethical and moral dimensions of economics and markets.
Increasing interest from sovereigns, and national and multi-national corporations to finance various development projects and economic activities has encouraged the expansion of innovative Islamic financial products among which *Sukuk* became well-known. The exceptionally high compound annual growth rate of *Sukuk* in recent years has undoubtedly made it a dominant segment in the Islamic finance industry.

The development of transportation, electricity and telecommunication infrastructure plays a vital role in sustaining robust economic activity. While many countries are struggling to meet their infrastructure needs due to strict regulations of the bank debt markets, *Sukuk* structures which are based on tangible assets offer a higher degree of prudence in managing macroeconomic and microeconomic elements that operate in the economy. Furthermore, the lack of flexibility in conventional infrastructure projects makes it difficult for governments to manage unpredicted events such as delays in revenue generation. On the other hand, the asset-backed nature of Islamic finance allows issuers to use *Sukuk* more flexibly over time as the return of *Sukuk* is generated from the underlying real assets rather than interest payments obligation. These factors have significantly encouraged the growth of *Sukuk* issuances in both Muslim and non-Muslim majority countries in recent years.

According to the Organization for Economic Co-operation and Development (OECD), the amount of annual worldwide investment in infrastructure is estimated to reach about $1.9 trillion between 2010 and 2020. Asia will face very large funding demands as it is likely to account for nearly half of the global spending on infrastructure development during this period. The establishment of Asian Infrastructure Investment Bank which include 20 Muslim-majority countries as founding members is likely to encourage sovereign *Sukuk* issuances in the coming decades. To date, the scope of most research papers has been limited to the discussion of *Sukuk*’s enormous potential for funding large-scale infrastructure projects. Nevertheless, a number of technical, legal and political obstacles emanating from certain ambiguities in *Sukuk* contracts continue to pose risks for new sovereign issuers. Hence, in this research chapter, opportunities, barriers and risks in relation to future *Sukuk* issuances that are proposed for the developing countries will be examined as an attempt to contribute to the expansion of sovereign *Sukuk* structures for a wider international investor base.

**Research Objectives and Questions**

The main aim of this research is focused on identifying and analysing the barriers which could pose obstacles for future *Sukuk* issuances by multinational financial institutions in general and Asian Infrastructure Investment Bank in particular. In doing so, this research attempts to provide different interpretations that contribute to the expansion of sovereign *Sukuk* structures for a wider international investor base. In order to achieve the aforementioned objectives, there are five important questions that need to be answered:

1. What factors impede the issuance of longer tenor sovereign i.e. up to 20 years?
2. How can neutrality be achieved with regard to tax implications on?
3. What is the role of offshore jurisdictions in current *Sukuk* issuances?
4. How can Islamic financial Institutions bring up an appropriate value proposition while entering into sovereign *Sukuk* transactions with developing countries?
5. Is it possible to develop international standards for accounting and statistical treatment of *Sukuk* instruments? If so, how can they be aligned with the existing international standards for accounting and statistics?
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