CHAPTER 1

INTRODUCTION

1.1 Introduction

Despite the short period of the emergence of Islamic finance in the modern era, this industry has received much attention from many scholars, researchers, and economists in an attempt to understand Islamic finance mechanisms. Such rational thinking behind the global adoption of the Islamic finance concept has led different financial institutions around the world to seriously study the core of the Islamic finance concept as an alternative to the conventional concept of the finance industry, which has revealed many failures despite the use of these conventional ideas for a considerable period of time (Iqbal & Molyneux, 2005).

Islamic finance, at present, still represents an average proportion of the global financial market, but its growth during the recent decades has not gone unnoticed. Islamic finance no longer operates in specific geographical centres with a limited range of products that are aimed at practising and devout Muslims, but, thanks to the financial innovation developed in recent years, has begun an international expansion that includes an expansion of its product offering.

There are many reasons behind the recent growth in Islamic finance. The first and most important reason behind this growth is the strong demand from many Muslim investors for Shari'ah-compliant financial services and transactions. The second reason is the growing oil wealth in Gulf Cooperation Council (GCC) countries that have a majority of Muslims, in conjunction with the growing demand for suitable investments that are spreading globally. The third reason is the competitiveness of many products

that have attracted Muslim and non-Muslim investors. Despite this rapid growth, Islamic finance remains quite limited compared to the global financial system.

Sukuk as a financing instrument has received attention from several parties, issuers, Sukuk holders, potential investors, firm managers, fund managers, and governmental bodies. All these parties strive to gain an advantage from the Sukuk activities. However, these advantages vary over time, starting from the announcement stage in the primary market to the trading stage in the secondary market; each stage represents special importance for the different stock market participants. The timeline of Sukuk starts from the announcement of Sukuk to the maturity date. This period is divided into several stages based on either the market type (i.e., primary or secondary market) or the transfer of Sukuk ownership, as shown in Figure 1.1. This study focuses on three phases based on the ownership transfer. The ownership of Sukuk in the first phase belongs to the Sukuk issuer, while, in the second phase, it belongs to the Sukuk-holder in the primary market. The third phase represents the ownership transfer among investors within the secondary market. In each phase, the behaviour of Sukuk varies, which is due to several economic and financial drivers over the timeline of Sukuk.

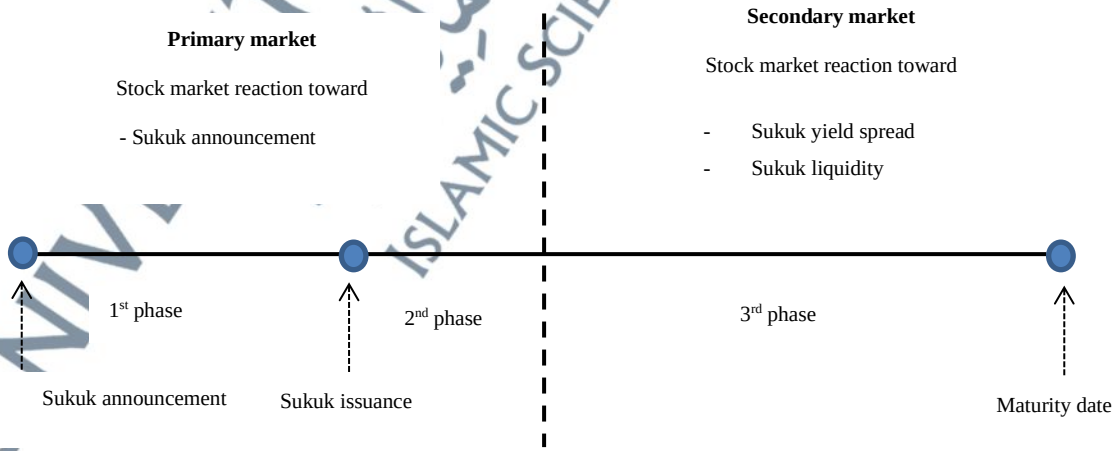

Figure 1.1: Timeline of Sukuk Activities

Several previous studies have addressed different reactions from the stock market, which varies due to many economic drivers (e.g., inflation, interest rate, taxation policy, and so on) and financial drivers (e.g., corporate governance regulation, accounting rules, bank system). Therefore, stock market participants seek to understand the behaviour of Sukuk at the announcement stage, which allows them to adopt optimal dynamic strategies for Sukuk issuance assessment. In this regard, Sukuk has very distinctive characteristics that must be taken into consideration when analysing the stock market reaction to Sukuk announcement. First, Sukuk undergoes a screening process to ensure their Shari'ah compliance by Shari'ah advisors. These instruments must notably be free from prohibitive elements by Shari'ah like riba (interest), gharar (uncertainty), maysir (gambling) which are prohibited activities. This certification is of much importance to potential buyers of Sukuk, such as Islamic banks, to ensure that they are compliant with Shari'ah. Hence, the approval of Shari'ah audit can influence the stock market reaction to Sukuk issues as a better quality can favour the ability to sell the current and future issued Sukuk. As a whole, the "religious certification" granted by Shari'ah scholars is a key element in differentiating between conventional finance and Islamic finance. Second, Sukuk structures can take different forms. The first category includes those based on profit-and-loss sharing, such as Musharaka and Mudaraba. They are defined as partnership contracts in which the investor and the borrower share the return. The second category includes the debt-based instruments like Ijara (rental/lease agreement) and Murabaha (cost-plus sale), in which a predetermined rate of return is paid to the investors; this category of Sukuk structure is permissible under Shari'ah because it does not contain interest in the strict sense.

Once Sukuk is issued, stock market participants shift their concern towards gauging the yield spread of Sukuk, which is a key metric of the relative risk. Typically,

stock market participants, such as investors or fund managers, pay more attention to the yield spread. This is due to the higher risk accompanying the higher yield spread of Sukuk. Investigating the yield spread of Sukuk at this stage is important to understand the extent of the co-movement between the outstanding and new issues of Sukuk. The shift of Sukuk yield spread, either the outstanding or new issues, may be explained by a shock within the stock market (e.g., change in interest rate, exchange rate). The yield slope reflects the effect of these shocks on the short-term yields, which will result in a change in the degree of steepness of the yield curve. The key factor that often alters the slope of the yield curve is the change in the market expectations, which are affected by the domestic monetary policy. As central banks generally target a very short-term interest rate, a shift in the market's expectations of a lower future policy rate, for example, will cause the yield curve to flatten, thus reflecting lower short-term interest rates in the future.

Besides the relative importance of the yield spread in the second stage for several parties, the liquidity of Sukuk is one of the vital behavioural characteristics, and deterioration of Sukuk liquidity leads to an increase in the liquidity premium of Sukuk and the level of Sukuk credit risk. Furthermore, the lower liquidity of the current Sukuk in the market is expected to circulate the same level of liquidity to the new Sukuk issuance, which, in turn, may cause additional losses of new issuances. Sukuk has attracted immense interest from investors around the world and has prompted intensive studies to explore the determinants of Sukuk liquidity.

1.2 Problem Statement

According to Duqi and Al-Tamimi (2019), most of the Sukuk holders hold their Sukuk till the maturity date. In this regard, over the timeline of Sukuk activity, Sukuk

holders must possess sufficient knowledge about these activity mechanisms and how Sukuk value can be affected positively or negatively. But, according to Hosen, Kebir, and Foong (2018), "the public awareness of the basics of Sukuk instruments is poor, literature is not available even at the counters of banks" (p17). This low awareness has affected the liquidity of Sukuk within the secondary market, which has extended its effect on the stock market liquidity and the whole economy due to its effect on the monetary supply and the life cycle of money within the economy.

Based on the main motivation of this thesis, as explained above, three sub-motivations are constructed. They are discussed separately in the following subsections.

1.2.1 Sukuk Announcement and Stock Market Reaction

The body of empirical literature discusses the stock market reactions to debt announcements and has motivated many researchers to develop theories that explain the stock market reactions towards debt announcements. Notwithstanding the concern of scholars about the impact of conventional bonds on the stock market reaction, few scholars have investigated the impact of Sukuk announcements on the stock market. In this context, most of the previous empirical studies focused on the Malaysian stock market, as, globally, it is the largest market of Sukuk (Archer, Davies, & Karim, 2017; Naifar & Hammoudeh, 2016). Meanwhile, little concern has been given to other Sukuk issuer countries, such Saudi, United Arab Emirates, Qatar, Turkey, Pakistan, Bahrain, and Yemen, due to the low issuance frequency. This has encouraged scholars to study Sukuk announcement impact regionally, for example; the study of Elian and Young Taft (2014a) on the GCC stock market, or studying the impact of Sukuk announcements on a cluster basis, such as the study of Alam, Hassan, and Haque (2013), which documents

its results for seven stock markets (Malaysia, Indonesia, Singapore, Pakistan, UAE, Bahrain, and Qatar).

This study differs from previous studies that investigated the stock market reaction toward the Sukuk announcement, as it focuses on two regions – GCC and Southeast Asia. Both these regions are considered as main markets of Sukuk, as the majority within these two regions follow Islamic Shari'ah. The different capital market structure of these two regions has motivated this study to investigate whether there is a substantial difference between these two regions. The capital companies structure of the GCC region is heavily skewed towards bank assets, which, as of 2016, formed about 58.8% of the total capital market structure, while the equity part formed around 34%, and debt securities around 7.2% (Azzam, 2016). Meanwhile, for the Southeast Asia capital market (i.e. Malaysia and Indonesia in this study), around 38.21% were bank assets, 38.07% for equities, and 23.72% for debt securities (Regan, 2017). According to Brugler, Comerton-Forde, and Hendershott (2020), the capital market structure reforms reduce the intermediation and lower the costs of raising capital. To the extent that the stock market suffers from excess intermediation and illiquidity, carefully crafted market structure reforms could improve investment and risk-sharing in the economy.

Besides the different capital market structures between the GCC and Southeast Asia, the regulation and supervision of the Sukuk issuance process are different (e.g., Saudi Arabia). Saudi Arabia is the largest Sukuk issuer within the GCC capital market (Khudari & Saad, 2019), but there is a lack of differentiation between Sukuk and conventional bonds by the authority body (Alshamrani, 2014). Despite the similarity of the Sukuk structure between the GCC and Southeast Asia countries, which are limited to seven structures of Sukuk – Wakala, Hybrid, Ijara, Mudaraba, Musharaka, Murabaha,

and Islamic exchangeable (Kamaluddin, Manan, Khadijah, Sufian, & Nu Nu Htay, 2015) – the absence of a Shari'ah committee to approve the Sukuk issuance and regulated forms is the main drawback (Alshamrani, 2014).

Therefore, investigating the impact of Sukuk announcements on the stock market within two different emerging markets with different regulations, institutions, and market structure, the stock market effects associated with the announcements of Sukuk announcements in the GCC stock market could be different from those in Southeast Asia countries. Moreover, implications are expected from investors, especially those with a religious orientation, as they prefer to go for compliant instruments that have been approved by a Shari'ah committee. Also, international investors will benefit by taking into consideration avoiding investing that has heavily negative stock market reaction upon Sukuk announcement, which can be conducted via shifting to the stock market that has less negative reaction from the stock market. Specifically, when they face a temporary shock in the stock market related to Sukuk announcement.

A notable negative stock market reaction and high volatility were reported among the Malaysia stock market (Thampanya et al., 2020), GCC stock market (Alqahtani et al., 2020), and Indonesia stock market (Susanto et al., 2021). The stability of stock market performance is associated with several determinants. The announcements of Sukuk are considered as one of the determinants of stock market reaction (Qizam, 2021). According to Khartabiel et al. (2020), there is increased demand for Sukuk, specifically, post the global financial crisis. Hence, investigating the potential effect of Sukuk announcement on the stock market reaction may help in mitigating the negative reaction from the stock market.

Predicting the stock market reaction towards debt announcement is initially based on two primary theoretical perspectives – trade-off theory and pecking order theory –

which are the most common financial principles for structuring the capital of a firm. In light of the trade-off theory, the capital structure of a firm is determined based on the balance between the cost and benefit of the external finance, while taking into consideration that the firm management is able to decide to what extent it relies on debt financing. Hence, when a firm expects more cash flow, it moves towards debt financing to benefit from the tax shield, which is positively interpreted by the public. In contrast to the trade-off theory, the pecking order theory interprets decisions about the capital structure based on three ascending levels of finance, in which each financing level decision is interpreted by the public differently. Basically, although a firm uses its retained profit to finance its capital structure as it is considered the first source of financing, it relies on debt financing in the second level since it reflects a less profitable firm position. This action by the firm with asymmetric information leads to a negative public reaction as the cost of capital financing by debt increases with asymmetric information.

These two theories have always been used to predict the stock market reaction towards debt issuance announcements. Despite the ignorance of the asymmetric information role in the trade-off theory, the pecking order theory is not a suitable alternative to the trade-off theory as it also ignores the issue of so much accumulated financial slack among firm managers (Liesz, 2005). The gap from the role of asymmetric information can be presented by highlighting the role of a time-lapse for interpreting information about financing decisions.

Irrespective of the limitations of the studies that investigated the impact of Sukuk announcements on stock market reaction, the most relevant issue is represented by the conflicting findings of previous studies in terms of identifying a unified reaction towards the Sukuk announcement. Based on the reviewed literature, the stock market

reaction towards the announcement of Sukuk is still in debate. For instance, Ashhari (2009) and Ibrahim & Minai (2009) found a significant and positive reaction from the stock market towards the Sukuk announcement, while Godlewski, Turk-Ariss, and Weill (2013) revealed a significant and negative reaction from the stock market towards the Sukuk announcement. Meanwhile, the study of Modirzadehbami and Mansourfar (2011) revealed a non-significant influence on the stock market reaction. This conflict is due to the different periods tested in earlier studies as the period involves a period of more stable growth during which the average impact tended to be affected positively, while extending the tested period to include an unstable situation will have a negative or almost slightly positive impact. Therefore, filling this gap by extending the tested event in five emerging markets instead of periodically will provide a better explanation about the behaviour of the stock market reaction towards the announcement of Sukuk. It is also expected to show the influential factors from a regional view.

The influence of regional factors on the formation of the financial structure is analyzed by comparing samples of companies belonging to different geographical areas, mainly between different countries. The first studies in this regard focused on listed companies. The study by Rajan and Zingales (1995) considered one of the pioneering studies on this subject, studies the level of indebtedness of companies belonging to the G7 countries, and concludes that although company factors have a similar behavior in all countries, there are differences that may have their origin in these regional factors. Subsequently, studies such as those by Demirgüç-Kunt and Maksimovic (1999) conclude the existence of differences in the form of financing, shown by companies as a result of differences, both in the degree of development of financial markets, and in the development the legal system of each country; Booth, Aivazian, Demirguc-Kunt, and Maksimovic (2001) establish these differences based on the characteristics of the

different countries, such as GDP, the level of inflation, the fiscal environment and the level of development of the different financial systems, how the legal systems of the different countries play a fundamental role in the development of financial markets and in the ease of access to credit available to companies; Psillaki and Daskalakis (2009) establish how legal systems not only directly influence the level of indebtedness of companies, but also condition the behavior of company factors with respect to said formation.

1.2.2 Sukuk Yield Spread and Stock Market Volatility

The interaction between bonds and stocks has motivated several studies about this interrelation, in which the level of bond volatility increases may affect the stock return. This implies that both the conditional means and the conditional covariance of a stock market change over time are influenced by the shocks and volatilities of the bond/Sukuk markets. Carvalho (2007) proposed a multivariate GARCH model that estimates the interdependence and contagion among international financial markets; parameterizes the conditional variance and identifies the structural changes when it undergoes the transition from moments of stability to periods of disorder. Subsequent advances include studies to detect the effect in which the responses of volatility to negative disorder differ from those caused by a positive disorder, which has given rise to several extensions of the original models of conditional autoregressive heteroscedasticity (ARCH) and heteroscedasticity models generalized autoregressive conditional (Rist, Garchitorena, Ngonghala, Gillespie, & Bonds); among them are the EGARCH or GARCH exponential of Nelson (1991) and the TARCH or ARCH threshold of Glosten, Jagannathan, and Runkle (1993), and Zakoian (1994). These models are applied for

conventional instruments, either bonds or stocks, and are used to estimate the interdependence between conventional bonds and stock over a specific time.

The need to estimate the interdependence and contagion among the financial assets becomes a necessity during times of high market uncertainty (Aloui, Hammoudeh, & Hamida, 2015). The necessity of this estimation is derived from the need for asset adjustment, which provides predictable results of the interdependence and contagion among the financial assets that helps portfolio managers and investors maintain a tolerable risk level. The time period 2014-2017 witnessed notable market uncertainty within the Southeast Asia market. The sharp decline in the exchange rate over the period 2014-2017 caused a shock within the Southeast Asia stock market (Mensi, 2017). Hence, there is a need to make an estimation of the interdependence and contagion among the financial assets. As the Malaysian and Indonesian financial markets are dominated by the Islamic financial instruments (Archer et al., 2017), the need to estimate the interdependence and contagion between Sukuk and stock market volatility in the Malaysian and Indonesian market has motivated this study.

Several previous studies (Lindvall, 1977; Sorensen, 1982; Wasserfallen & Wydler, 1988) reported that new bond issuances displayed higher yields than the matched benchmarks, which rely on the bases of maturity, call-ability, and credit rating. All these factors make the corporate bond under-priced. The situation of under-priced credit rating is temporary. For example, Fung and Rudd (1986) concluded their study by stating that investors will seek to extract the related information to the bond price data, which will lead to price equilibrium. In this context, according to other researchers (Conard, 1966; Conard & Frankena, 1969; Frankena, 1971; Jen & Wert, 1966), this was found to result in a non-perfect substitute between the new and the existing bond in terms of pricing (Ederington, 1974). Fung and Rudd (1986) provided three different

explanations behind the different price of the new and existing bond. The first explanation is that this is attributed to the different features of the contract between the existing and new bonds, while the second explanation points to the higher level of liquidity of the new issuance. The third explanation is related to the different cost of issuance as a result of a new financial and economic situation. Here, the explanations of the differences between the new and existing bonds by Fung and Rudd (1986) have been a topic of argument for many other scholars and researchers (Bhagat, Marr, & Thompson, 1985; Kessel, 1971; Kidwell, Marr, & Thompson, 1984; Sorensen, 1979). Their argument is closer to the third explanation in that new issues may be priced to yield a differential from the equilibrium value in order to reflect the transaction costs in delivering the issue to the marketplace.

Ederington (1974) provided three hypotheses to explain the yield spread on new issues of the bond. First, there is a non-perfect substitute between the new and outstanding bond issues that have the same industrial classification and quality rating. This attributes to the similar conditions of both issuances. In this regard, differentiating between the new and seasoned Sukuk relies on that the outstanding Sukuk issuance in the market is considered as seasoned, while the second issue is considered as new, taking into consideration that both issuances have the same industrial classification and quality rating, where any Sukuk that has no second issuance were excluded.

This hypothesis is known as the Heterogeneity Hypothesis. Secondly, secondary bond market yields tend to lag behind new issue offering yields, thus resulting in a prolonged, though non-permanent, yield spread. Although the reasons for this hypothesized lag have not been clearly stated, clearly such a lag is expounded because there is no free substitution between new and outstanding issues in the bond holder's

portfolio. Thirdly, the uncertainty hypothesis supposes that the yield spread resulted from the uncertainty of the new bond issues.

In respect of the Sukuk yield spreads, with the exception of two previous studies in the Sukuk field, which were conducted by Rahman et al. (2013) and Naifar & Mseddi (2013), most previous studies were conducted based upon conventional bonds. Nevertheless, these two studies did not differentiate between new and seasoned issuances of Sukuk. Hence, there is a lack of understanding regarding whether new and seasoned issuances can be affected by the same factors and whether or not it has the same co-movement to the stock price volatility.

1.2.3 Sukuk Liquidity and Stock Market Liquidity

The main objective of the firms is to maximize its value, which induced several previous studies to seek those channels that link to the firm value. In this regard, the liquidity effect is one of the channels that link to the firm value. Investigating the link between bonds and the stock market liquidity has received much attention recently. Despite the high concern about this relationship, unexplained areas remain that need to be explained (Anderson, 2017). Several previous studies (Bernile, Korniotis, Kumar, & Wang, 2015; Ejsing, Grothe, & Grothe, 2015; Huang, Huang, & Oxman, 2015; Shih & Su, 2016) have investigated the impact of liquidity among different financial asset classes, but few studies have focused on the linkage between bond liquidity and stock market liquidity. The study of Anderson (2017) is considered to be the first study that filled the gap in the understanding concerning the liquidity link between conventional bonds and the stock market liquidity. Anderson (2017) employed the Seemingly Unrelated Regression (SUR) event study methodology of Schipper and Thompson

(1983), which motivates this study to provide an understanding of the link between Sukuk liquidity and stock market liquidity.

The low frequency of bond (either Islamic or conventional) transaction information is an obstacle for investigating and interpreting the link between bond liquidity and other financial assets' liquidity. However, the latent liquidity model of Mahanti et al. (2008) offers a new approach to overcome this obstacle, as it depends on the monthly basis of transaction information instead of a daily basis. Hence, the application of this approach required the availability of monthly data frequency. For this reason, the Malaysian market is targeted by this study as it is considered to be the largest market of Sukuk trading in the secondary market, besides the availability of this market data, which would strengthen the feedback results of the study.

Although defining liquidity in theoretical terms is quite easy, defining an accurate empirical measurement is quite difficult (Mahanti et al., 2008). This is because most liquidity measurements depend on the high-frequency information of bonds, which can be relatively tied to trading spreads and volume. Therefore, bonds with a low frequency of transaction information cannot be measured. This gap has formed an obstacle for measuring bonds that have a low frequency of transactional information. Mahanti et al. (2008) proposed a new metric for liquidity, called Latent liquidity. This measurement closes the gap between the high and low transactional information of bonds. Several previous studies (Dick-Nielsen, Feldhütter, & Lando, 2012; Gissler, 2017; Nashikkar, Subrahmanyam, & Mahanti, 2011) employed the latent liquidity, but these studies only focused on the conventional bonds. The only study that focused on the Sukuk, and is limited to the Malaysian stock market, was conducted by Said, Suhaimi, Nurhanan, & Haris (2013); it examined four liquidity determinants: issuance amount, maturity,

coupon rate, and age. The gap between Sukuk liquidity and stock market liquidity is still incomprehensible, which will be investigated in this study.

1.3 Research Questions

This study is constructed to answer three questions as follows:

1. How of the stock market reaction to the corporate Sukuk issuance announcement?
2. How is the co-movement between the new and seasoned corporate Sukuk issuance yield spreads and the stock market volatility?
3. What is the effect of corporate Sukuk liquidity on the stock market liquidity?

1.4 Research Objectives

The current study aims to achieve the following research objectives:

1. To investigate the stock market reaction to the corporate Sukuk issuance announcement.
2. To determine the co-movement between the new and seasoned corporate Sukuk issuance yield spreads and the stock market volatility.
3. To identify the effect of corporate Sukuk liquidity on the stock market liquidity.

1.5 Significance of the Study

1.5.1 Sukuk Announcement and Stock Market Reaction

A significant contribution of this thesis is that the current study attempts to illustrate that even a simple characterization of issuance motives can provide new and

improved insights into stock market reactions to the Sukuk issuance. Exploring the market reactions towards the issuance of Sukuk will help current shareholders and potential investors to make their decisions about the financial situation of the company and assist them in realizing the optimal Sukuk structure that acts positively on the company stock price in the financial market.

In addition, the present study provides useful information about the impact of debt securities issuance, in general, and Islamic bond issuance, in particular. This would pave the path for firm managers to make the right decision about the appropriate issuing and announcing the time of Sukuk. Furthermore, the ultimate target of firm managers is to achieve a high return to the business, which contributes to increasing the firm value. For this purpose, previous related research has shown a significant and negative impact resulting from the issuance announcement. A comprehensive understanding of the announcement influence on the stock market provides valuable information, which, if used properly by firm managers, will allow them to determine the optimal timing, issuance size, and rating.

Clearly, the lack of knowledge of the announcement issuance effect may lead to issuance failure, which can be overcome by taking into account the affecting factors. Investors are led by the flow of information from the market, and their interpretation of this information is limited due to their partial knowledge about it. Thus, the avoidance of investors' negative reaction of the Sukuk issuance announcement requires a specific time, and the identification of such time relies on the many factors mentioned previously. Sukuk structure, rating, reasons for issuing, size of the firm, Shari'ah audit quality, and timing are those factors that impact the required different time from investors to have significant and positive reactions towards or to continue their negative reaction to the issuance announcement.

1.5.2 Sukuk Yield Spread and Stock Market Volatility

Taking the right decision by firm managers about the optimal financing tool in order to maximize the shareholders' value must be based on many assumptions. Moreover, releasing sufficient information to the external environment of the business may indicate that management should ensure the strong financial position of the firm. Furthermore, potential investors have different levels of risk tolerance, which affects their response towards the related risks of several investments (Bodie, Kane, & Marcus, 2012; Van Horne & Wachowicz, 2008). These responses were the focus of many scholars' attention and estimating the market response towards restructuring the firm capital remains a mystery. Different yield spreads of bonds have been noted for the last two decades. Precisely, various conditions have affected the obtained evidence from the financial market. The second objective of this thesis will discuss the different stock market reactions towards the yield spreads of a new and seasoned Sukuk issuance, taking into consideration the impact of other economic factors, such as local exchange rate and oil price.

For portfolio managers, the stock and Sukuk yield spread co-movement and correlation play a crucial role in cross-market hedging, asset allocations, and risk diversification. Although extensive research has investigated the co-movement and correlation between conventional stocks and bonds in the empirical finance literature (D. Baur & Lucey, 2006; Emenike, 2017; Martin & Zhang, 2014), there are no previous studies devoted to such issues in the Islamic capital market literature.

Furthermore, the emerging unified Sukuk market initiative, which was initially discussed at the *'Regional Forum on the Role of Islamic Financial Institutions in Financing for Development'* in 2007, and re-launching the initiative by the Saudi Capital Market Authority (CMA) and the World Bank (WB) in 2016, which was held

at *'The second Sukuk Conference for the Role of Debt Markets in Economic Growth'*, emphasized the need for clarifying an integrated Sukuk structure and documentation in order to pave the way for the establishment of a unified Sukuk market.

In order to achieve this initiative, this study focuses on clarifying the differences and similarities of the two regions, namely Southeast Asia and GCC, which dominate over 85% of the total outstanding Sukuk issuances. Hopefully, the results of the present study will provide a regional perspective on the corporate Sukuk announcement, yield spread, and liquidity determinants, as well as its influence on the shareholders' wealth.

Besides the practical significance of the second objective, the theoretical significance will be achieved in two ways; first, this study fills the gap by investigating the differential impact of new and seasoned Sukuk yield spread on the stock market, which is considered as a new area of the Sukuk link to the stock market volatility. Second, it will help scholars of Islamic finance to model the optimal portfolio diversification, based on the feedback of the results about the interdependence between Sukuk yield spread and stock market volatility.

1.5.3 Sukuk Liquidity and Stock Market Liquidity

Every company must take care of its performance since to obtain internal and external financing funds, it is interested in its margins so that they are given adequate benefits. It is the responsibility of the management to efficiently reach the more liquid resources that support minimizing the cost of the different financing sources which are counted, since it must seek an appropriate combination of the internal and external financing sources to maximize the profits of the company, as well as to provide a higher level of liquidity. The need to properly select liquid funding sources arises from recognizing that the resources are limited and expensive.

Liquidity can be defined as the ability to trade an asset in the market easily, that is, expeditiously, with low transaction costs and little impact on stock prices. At first glance, this seems to be well established, and liquidity is a concept widely used by investors around the world. But what is not so evident is whether liquidity is valued, that is if there are variations in asset returns that are explained by changes in market liquidity. This thesis will seek to answer this question in the context of the Malaysian corporate Sukuk market. Liquidity is a factor that could be valued by the market since liquidity is a risk that the investor must face when trading a Sukuk in the secondary market. Illiquid assets are likely to be more difficult to buy and sell, incurring higher transaction costs and possibly suffering a lag between the time the order is placed and the transaction itself. In conclusion, liquidity can be a source of risk, which would affect the prices, spreads and returns of the bonds. This thesis focuses on the Malaysian corporate Sukuk market because they have orders of magnitude of less liquidity than the conventional bonds.

Liquidity is a difficult concept to measure empirically, for two reasons. First, because liquidity consists of several concepts (transaction frequency, transaction cost, impact on prices, lag between the order, and the execution thereof) and finding a measure that rescues all these concepts is difficult. Second, because more illiquid assets are less traded in the market, they generate less information that can be used to calculate some measure of liquidity. In order to analyse and measure liquidity in the best possible way, this study is considered to be the first to adopt a new measurement of liquidity, which has not been previously applied for Islamic bonds.

1.6 Operational Definition of Terms

1. Sukuk: Sukuk term within this study refers to the Islamic certificate holds by an investor, either this investor, an individual or a corporate unit; this certificate complies with Islamic financial law.
2. Sukuk announcement: Refers to the official declaration of a corporation that intends to issue Sukuk on a determined date at the official declaration.
3. Sukuk yield spread: Refers to the difference between Sukuk yield and treasury bills issued by the government.
4. Seasoned Sukuk issuance: A seasoned Sukuk issue is an additional issuance of Sukuk from an established company whose securities already trade in the secondary market. The seasoned issuance is considered as seasoned if it shares the same quality, coupon rate, and maturity as the Sukuk issuances already trade in the secondary market.
5. Sukuk liquidity: Refers to the frequency of trading a determined Sukuk within the secondary market, where a higher frequency of Sukuk trading indicates higher Sukuk liquidity.
6. Stock market: Refers to the official place organized by the government for the purpose of trading on several types of financial assets such as shares and bonds.
7. Stock market reaction: Stock market reaction within this study refers to an abnormal return that occurs by the stock market index, either this return in a negative or positive direction.
8. Stock market volatility: Refers to the dispersion of stock market index returns over a specified period.

9. Stock market liquidity: Refers to the difference between the bid and asked prices of financial assets such as shares and derivatives at the secondary market.

1.7 Organization of the Thesis

This thesis contains six chapters. It is structured in a way to cover three issues relevant to the Sukuk activities. The first chapter focuses on four areas, the motivation of the study, research gap, research objectives, and significance of the study. The second chapter provides a background of Sukuk market development, a comparison between Sukuk and conventional bonds, Sukuk structure, Sukuk issuance, Sukuk issuance process, Sukuk issuance announcement, Sukuk secondary market, Sukuk rating, and, finally, the background of the GCC. The third chapter is divided into four main areas; the first three areas discuss related theories and previous studies for each Sukuk activity – announcement, yield spread, liquidity, and the stock reactions – while the fourth area is assigned for the concluding remarks. The fourth chapter describes the research methodology used for each Sukuk issue discussed in the study. Also, the third chapter clarifies the hypotheses development of this study, used methodology, data description, and empirical models. The fifth chapter provides empirical result of the study, each Sukuk activity investigated has provided in separate section. The sixth chapter is the final chapter, it includes the summary of findings, contribution, and limitation of the study.

CHAPTER 2

SUKUK BACKGROUND

2.1 Introduction

Sukuk is the Arabic name for a financial certificate. It is essentially a certificate of the ownership of assets that can be used on a large scale for infrastructure and investing finance. The Islamic Financial Services Board (IFSB-2) defines Sukuk as *"Certificates that represent the holder's proportionate ownership in an undivided part of the underlying asset, where the holder assumes all rights and obligations to such asset."* This concurs with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) definition: *"certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity."*

Sukuk, as a financial instrument, has attracted more attention during the last three decades, prompted by the rapid demand for alternative financing instruments. Sukuk provides a new concept of debt, which presents suitable debt characteristics that comply with Islamic law, as well as a profit-sharing approach that is tied to existing assets. The Sukuk market development has been accompanied by a notable development in their regulatory legislation. This rapid development has contributed to the spread of the Sukuk market globally.

This chapter is organized to provide an overview of Sukuk as follows. Section 2.2 outlines the rapid growth stage of the Sukuk market over the last three decades. Section 2.3 clarifies the major differences between Sukuk and conventional bonds. Section 2.4 illustrates the popular Sukuk structure. Section 2.5 details the Sukuk issuance

regulation. Section 2.6 provides information concerning the Sukuk issuance process. Section 2.7 provides a background of the Sukuk issuance announcement. Section 2.8 explores the secondary market emergence, supervisory, and development in Malaysia. Section 2.9 gives information about the Sukuk rating procedures. Section 2.10 provides a background of stock market index. Section 2.11 explores the stock market liquidity. Finally, the chapter's concluding remarks are in section 2.12.

2.2 Sukuk Market Development

The beginning of the Sukuk market dates back to the late eighties. The ruling of Sukuk by the fiqh academy of the Organisation of Islamic Cooperation (OIC) has formed the main point of Sukuk market emergence (Hassan, Kayed, & Oseni, 2013). The legislative base taken on the basis of OIC ruling has paved the essential ground for Sukuk issuers to penetrate the financial market. Consecutively, several types of Sukuk have been issued and offered on the market, which represents the second phase of Sukuk market development.

2.2.1 Sukuk Market Emergence

The Sukuk market has recently penetrated the financial market. The emergence of the Sukuk market highlighted the urgent necessity to create a safe market for Islamic debt transactions. Malaysia is considered to be the pioneer in establishing Sukuk instruments. The credit for issuing the first Sukuk goes to the Malaysian market. The Sukuk was issued by Shell MDS Malaysia in 1990, with an amount of RM125 million (USD 30 million), which was classified as a corporate Sukuk and structured as Al Bai' Bithaman Ajil Sukuk (Bassens, Engelen, Derudder, & Witlox, 2013). Meanwhile, the first sovereign Sukuk issuance was by the government of Bahrain in 2001; the issued