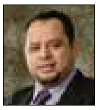
# Secondary markets for Islamic finance revisited



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**A secondary market is basically the market where financial instruments are traded among investors. In the secondary market, entities issuing financial assets do not receive funds from the buyers. Those entities, whether they are corporations or governments, also called issuers, will already have received the funds needed when they first issue two main instruments of capital markets, either equities or bonds, in the primary market.**

The continuous trading in the secondary market updates issuers with the agreed daily price that the securities command in an open market. The secondary market also offers an ongoing opportunity for investors to liquidate their investments in securities. Here, the secondary market provides them with liquidity and prices for the securities they own or desire to purchase; and the market also puts together buyers and sellers.

## Review of 2019

Considering that Islamic finance operates within the context of existing conventional global financial markets, Islamic financial instruments also need some features of conventional financial markets. Hence, a liquid Islamic secondary market is also needed to foster the growth of an Islamic primary market. One of the challenges now facing Islamic capital markets, especially their Sukuk market, is the lack of liquid and active secondary markets.

Different from Islamic equity markets, where the approach used to consider a listed equity as a Shariah compliant equity is by applying qualitative and quantitative screenings to existing stocks traded in global financial markets, Sukuk markets are created through a special process of issuing Sukuk done by corporations, supranational entities and governments. Thus, the state of secondary markets for Islamic equities is relatively not that different from conventional equities. Furthermore, many global indices such as MSCI, FTSE and DJIM have also developed their own Islamic indices.

The issue of inactive secondary markets has been discussed for some time. The International Islamic Liquidity Management Corporation in 2015 stated that there has been a deficit of supply and limited secondary market activity, particularly in cross-border trades. The IFSB in the same year also contended that issues of liquidity and activity of Sukuk secondary markets in key Islamic finance places are limiting the ability of investors to trade Sukuk instruments.

Deloitte in 2016 pointed out that there is a prevailing culture of 'buy and hold to maturity' in Sukuk markets. This is because investors buying Sukuk in primary markets normally do not sell their Sukuk in secondary markets due to the scarcity of Sukuk supply. Similarly, Thompson Reuters in 2017 also raised this 'hold to maturity' issue due to the fact that Islamic financial institutions invest greatly in Sukuk as their options of investment are limited to Shariah compliant instruments.

## Preview of 2020

Although there has been increasing Sukuk outstanding over the time, reaching around US$470 billion in 2018 (Islamic Finance Development Report, 2019), the amount is still very small compared to over US$100 trillion of outstanding bonds in 2017 (CISI, 2019). However, it means there is still ample room for the growth of Sukuk. Furthermore, the experience of the markets so far has shown the demand for Sukuk issued in the primary markets has always exceeded the supply.

Therefore, considering that the development of primary markets will automatically contribute to the development of secondary markets, more issuance of quality Sukuk in the primary markets will boost the secondary markets. Looking at the infrastructure needs in Muslim countries worth tens of trillions of dollars in GCC countries, Indonesia, Malaysia and also African countries, this actually could be an important primary driver for more issuance of Sukuk in primary markets.

Moreover, at the moment, the Sukuk market is still concentrated in a small number of countries where five countries — Malaysia, Saudi Arabia, Indonesia, the UAE and Turkey — accounted for 91% of total Sukuk outstanding in 2018 (IFSB, 2019). However, it is important to note that the alleged challenge of more complexities in issuing Sukuk compared to conventional bonds should be addressed so that it can attract more newcomers to the markets.

Other initiatives to enhance the secondary markets for Sukuk are:

(i) Creating more dealer markets and trading platforms that can perform the trading of Sukuk: These dealer markets will play a role in either absorbing the Sukuk issued in the primary markets or purchasing the Sukuk sold in the secondary markets. A positive development in this area took place in Saudi Arabia where the government initiated a new 'primary dealer' scheme for local-currency government Sukuk.

(ii) Establishing an Islamic megabank. It is expected that an Islamic megabank can contribute significantly to increasing the liquidity of Sukuk through primary issuance and fostering the growth of secondary Sukuk markets. The discussion on the establishment of an Islamic megabank involving the IsDB, Indonesia, Malaysia, Saudi Arabia and Turkey started a few years ago, but it has somehow stalled.

(iii) Developing more Islamic capital market instruments. Among a new innovation that can be explored is the creation of Mudarabah funds for the sale and purchase of quality Sukuk in secondary markets. Here, Islamic financial institutions can play the role of fund managers. Other innovations include creating more Sukuk issuance to retail investors. The government of Indonesia has implemented this instrument for the last decade and it has always been oversubscribed. This can be replicated in other markets too involving governments and corporates.

## Conclusion

One challenge facing Islamic secondary markets, particularly Sukuk markets, is an inactive and illiquid secondary market. One main reason for this is the 'buy and hold to maturity' culture in Sukuk markets. However, considering that as a whole Sukuk markets are still very small compared to conventional bond markets — total Sukuk outstanding in 2018 was just around less than 0.5% of conventional bonds in 2017 — one route to make Sukuk secondary markets more liquid and active is through creating even more issuances in primary markets.

To do that, the Islamic finance industry should address the issue of more alleged complexities in issuing Sukuk than conventional bonds, so that more new players will come to Sukuk markets and ease the reliance on only a few countries. Other than this, more dealer markets and trading platforms, an Islamic megabank and more Islamic capital market product innovations could also be used to enhance secondary Sukuk markets. In any case, considering the nature of Islamic finance, the level of activity of Sukuk markets may not need to be at the same speed with its conventional counterparts although it should not be lagging too far behind either.