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A Compilation of Contemporary Sukuk Risks

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Abstract
Sukuk and conventional bond operates in the same market but the prohibition of interest in Shariah restricts sukuk within profit sharing operation and thus differentiates it from interest based bonds. Investors are required to share risks with entrepreneurs under this Islamic instrument which often make it less competitive than its conventional competitor. This study reviews past literatures to compile all contemporary suck risk and discussesseveral mechanisms to mitigate those risk.A total amount of thirteen risks related to various aspects of Sukuk structure were identified along with four risk management techniques which were derived from the conventional equity market concept and found to be valid for Sukuk. The limited amount of literature on the Sukuk risk has limited the investigation and the qualitative nature of this study could not provide any empirical evidence of the extent of the risk to the investors. Information relating to Sukuk risk will benefit both Sukuk Security providers and investors to understand the potential problems ahead and takes precautions at an early stage to avert any disaster which has been experience in the conventional equity market.The extent of risk related to Sukuk covered in this study is the first of its kind as it explores all potential roots and finally offers techniques to prevent some of the risks for the investors benefit. Information provided through this study will serve as a guide for potential investors of Sukuk issues to make an informed decision and enable them to minimize the risk to secure a healthy return from their investment.
Keywords: Sukuk, Shariah, Riba, Islamic Capital Market, Risk

Introduction

In recent times the Islamic bond (Sukuk) market has registered a phenomenal growth all over the globe including non - Muslim countries. The attachment of riba or interest with conventional securities have made Sukuk a popular choice for investment among Islamic banks Islamic insurance companies in recent times as it is compliant with Shariah which prohibits income generated through interest. Furthermore, Sukuk is becoming highly demanded as there are an increasing number of Muslims of high net worth, who want their asset holdings to comply with Islamic Law (Wilson, 2008). The increasing popularity of Sukuk around the globe has allowed it to be a feasible alternative for conventional financial products in recent years and thus established as one of the most significant mechanism to raise finance through acceptable Islamic structure.

In conventional finance, interest rates are charged and if the borrower fails to repay in time the interest accrued is added to the principle and thus interest earns interest based on the length of the time the funds are utilized by the borrower (Saeed, 1995). In contrast the Islamic finance charges markup over the principal and when the default occurs in repayment, a penalty is charged (Al-Omar & Abdel-Haq, 1996). The Sukuk holder has the right not only to the cash flow of the asset and the right to possess the asset but also the right to get the proceeds from the sale of the asset which his more like hire purchase in conventional finance. There is a possibility that Sukuk investor will get a better return than governmental or conventional bond but high return is always associated with high risk.

According to modern portfolio theory, the construction of an effective investment portfolio depends on the tradeoff between maximization of return for a given level of risk or to minimize risk for a given level of expected return. This paper develops on the later point of view and tries to educate investors about various types if risks associated with investing in Sukuk. The concept of Sukuk is discussed briefly in the next chapter before going to an in depth review of risks related to Sukuk through the discussion of prior literature. Finally the paper conclude with drawing out few remedies for dealing with few of the risks discussed and the future areas of research on the subject matter. The primary focus of this paper is compile all possible risks related to Sukuk investment for informed investor interest.

Problem Statement

Several issues have been derived from Sukuk issuance such as imposition of late payment penalty on Sukuk issuer upon its default, trading at a discounted price for Sukuk representing debt, purchase undertaking in Musharakah and Mudharabah structure and ownership of assets in asset based Sukuk which posits this type of securities risky for the investors.

Dubai Sukuk crisis incident affected the image of Sukuk which was initiated under the Nahkeel Sukuk which was the largest of all. Dubai International Financial Exchange was the investment bank whereby the objective of this fund was to finance property development in one of the public enterprise sector in Abhu Dhabi Nahkeel Co PJSC.

Now, to make this Islamic financing instrument attractive to the investors, Sukuk issuers should deal with all the associated problems with sukuk investment. It is also a good idea for the Sukuk investors to understand the risks involved in such transactions so that they can take better decision and earn a healthy return. As such, paper has focused on identifying various risks associated with Sukuk and also discussed few possible ways to deal with them.

Significance of the Study

Sukuk is an emerging product which has attracted increased attention globally but to survive and secure a successful future, it will have to compete with an established conventional bond market which has already captured a majority portion of the market. In such a scenario, this paper provides a clear understanding of various types of risk associated with Sukuk and thus benefits both issuer and investors to take precautions against them and develop a strong market for Islamic financial securities.

Literature Review

The Concept of Sukuk

Sukuk is plural of the Arabic term "Sakk" which means certificate, legal instrument or deed and in general finance terms the work "Sukuk" refers to securities backed by real assets (Wijnbergen & Zaheer, 2013). Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI) defines Sukuk as certificates of equal value particular or special investment activity, however, this is true after receipt of the value of Sukuk, the closing of subscription and the employment of the funds received for the purpose for which the Sukuk were issued.

In simple terms, Sukuk are entitlement scripts with each sukk (script) representing a fractional ownership in an underlying asset or project, which may be an investment project or a property development project or a collection of underlying assets (Jabeen & Javed, 2007). By holding the Sukuk script and contributing a certain amount of an items price and operation which is bought or finance through Sukuk, an investor can become owner of such item. Returns on Sukuk is derived either from performance of an underlying asset or contractual agreement based on the asset. According to Wilson (2008) main principles underlying Sukuk issuance includes the clear definition of all rights and obligations, relations of income to the project being financed by the issue and the principle that Sukuk should be backed by a real asset.

The Malaysian Securities Commission however has its own definition with regards to Sukuk which refers to:

> *Certificated f equal value which evidence undivided ownership or investment in the assets using Syariah principles and concepts endorsed by the Syariah Advisory Council (SAC), but shall not include any agreement for a financing. investment where the financing / investor and customer / invesetee are signatories to the agreement and where the financing / investment of money is in the ordinary course of nosiness of the financer / investor, and any promissory note issued under the terms of such as agreement.*

The return on debt includes riba (interest) which is not permissible in Islam and thus Sukuk investors are not treated as lenders of money as it entitles him for a return. The investor who invests money or equity stake and its return in the form of capital gains and dividend are most suitable for Sukuk investment, if the investors are willing to put an equity stake and hold the funds till the project matures. This constitutes the main difference between Sukuk and conventional bond. Although both securities are backed by assets but Sukuk can only be backed by real assets whereas conventional bonds can take both financial assets and real estate as collateral.

Structures of Sukuk

There are various types of Sukuk depending on its usefulness. Some of the most common types of Sukuk includes Murabahah, Mudharabah, Musharakah, Ijarah, Salam and Istishna.

Murbahah

The seller of the Murabahah commodity is the issuer of the certificate in the case of Murabahah Sukuk. The issuer's obligation is to settle the purchase price, securitized via the issuance of Murabahah notes (Dar & Azami, 2010).

Mudarabah

Mudarabah Sukuk is investment sukuk that represents common ownership of units of equal value in the Mudarabah equity; the holder of Murdharabah Sukuk are the supplier of capital and owns shares in the Mudarabah equity and the returns according to the percentage of share ownership (Wilson, 2008). Parties involved in Mudarabah Sukuk must decide on the profit sharing ratio or validation purpose and Mudarib is not allowed to claim any periodical salary or a fee or remuneration for the work done for the Mudaraba apart from the agreed proportion of the profit.

Musharakah

Musharakah Sukuk represents ownership of equity and differs with Musarabah with the fact that the party issuing Sukuk forms a committee from the holder of the Sukuk and is referred to for investment decisions. Musharakah Sukuk is expected to provide return based on the performance of the project but fixing a fixed percentage profit rate or agreeing to inter – bank market rates could raise questions about the suitability of such Sukuk product in the Islamic capital markets.

Usmani (2007)states that the concept of Mushsrakah is a form of financing where a few partners enter into an agreement to form an enterprise in which all the partners share the profits or losses derived from the joint venture. Any kind of loss in the business is to be borne by all investors based on the ratio of their investment.

Ijarah

Ijarah sukuk refers to the ownership of equal shares of a rented estate which entitles him to receive rent in exchange of bearing all cost of maintenance of the damage to the real estate. Unlike lease financing under conventional methods, the responsibility to maintain the underlying asset under this arrangement rest on the financer (Bakar, 2000). Critiques of Ijarah Sukuk points to the fact that their structure bear close resemblance to debt based conventional bond issue due to the sale and lease back arrangement and the fixation of return.

Usmani (2007) explained that among the two types of ijara sukuk, the first one employs the services a person on wages given to him as a consideration for his hired services and the second one transfers the ownership of a property to another person in exchange for a rent claim by him.

Salam

Salam Sukuk refers to the sale in which payment is made in advance by the seller (Wilson, 2008). In case of short term financing this Sukuk is very popular. Advance payment of price are made for goods to be delivered in a certain time in case of this type of Sukuk.

Istisna

Istisna Sukuk represents certificates that carry equal value and are issued to mobilize funds required for production of goods and products that will be owned by the certificate holders. According to Ali (2008), the issuer of these certificates is the manufacturer, the subscriber are buyers of the intended product, while the funds realized from subscription are cost of the product. This type of Sukuk has developed on the principal that cash will be paid in advance for the goods manufactured and delivery of goods will take place at all time in the future.

Risk to Sukuk

This section of the paper will discuss about various types of risk related to Sukuk issues based on the review of past literature by various scholars. The popularity of Sukuk in the Islamic capital market had made many investors interested about this product but without proper understating of the risks associated with Sukuk issue, they are not going to be able make an educated decision. Sukuk needs to compete with conventional bond which is based on interest and has an established market around the world. The restriction of interest in Islam makes it challenging for Sukuk issues to motivate customers toward Sukuk products at the same time satisfy Shariah principle.

The combination of this two are difficult and the success of Sukuk depends on it. Being a new product and offered in an emerging market, there are several risks that limits the true potential for Sukuk to become an effective alternative of conventional bond. The first stage to cure a problem is to understand the root of the problem and this section will that purpose. A detailed discussion of various types is provided in this section of the paper followed by possible ways to mitigate those risk.

1. Default Risk

Default on loan occurs when the borrower becomes unable to pay interest or principal at due date and it affects in the interest rate charged on a debt instrument. The greater the default risk, the higher the interest rate charged by the lender. An increase in the riskiness of the borrower's operating cash flow will increase the likelihood of default. There is a possibility that Sukuk might promote default risk like any other conventional bond.

Sukuk however are claiming to be safer than conventional bonds as they theoretically transfer ownership of the underlying assets to the holders, who in turn will earn a return on holding the asset. But Majid et al. (2010)suggests that Sukuk default can occur due to the breach of any binding obligations under the original terms of the agreement between the issuer and the Sukuk holder.

There is an absence of international rating of most Sukuk issues and only half of all sukuk issue have been rated. There is also a lack of Islamic rating agencies and that leads sukuk issue to be rated by conventional rating agencies with incompetent mechanisms. This is done in spite of the fact that rating agencies are fully aware about the differences in structure of traditional and Islamic bonds (Al-Amine, 2008).

2. Rate of Return Risk

Most of the modern Sukuk Issue have a fixed payment. This gives rise to rate of return or interest rate risk as the Sukuk value becomes negatively related with market interest rates. This type of risk can be significantly reduced or avoided by structuring Sukuk according to Shariah[1]. According to Usmanim (2007), Sukuk structure cannot use fixed interest rates or market index, such as LIBOR as a return for the initial Sukuk investment.

The payment should reflect actual return of the underlying asset. Another noticeable problem might occur if actual return on Sukuk exceed the expected return as it might raise the notion of "false incentive" among managers who would expect incentives for better performance. Solution to this problem again lies on using the actual performance of the asset and distributing any surplus to sukuk holders.

3. *Foreign Exchange Risk*

In today's global economic perspective, a situation can occur when an underlying asset is not in the same currency as the sukuk certificate. This type of situation might lead to foreign exchange risk. Tariq (2004) brings an example of Chinese sukuk issue, where one part of sukuk was issued in US dollar and the remaining in Euro and also suggests that such risk can be avoided by using several currencies in a sukuk issue. The other aspect of the exchange rate risk is that the equity price is related to the exchange rate and market which affects the stakeholders in the project and can be overcome through parallel contracts (Ali, 2008).

4. *Shariah Compliance Risk*

Tariq & Dar (2007) describes Shariah compliance risk associated with sukuk as a risk of loss of asset value due to sukuk incompliance of Shariah principles. Shariah non - compliance nature of modern sukuk has been criticized by Shariah scholars and issuing such sukuk can destroy the reputation of the issue and affect trust of investors on the issuer. The problem occurs due to the involvement of Shariah scholars with the first stage of the sukuk structuring process Usmani (2007) while they are expected to be active during all stages of operation. Lack of standards in appointing members of Shariah board and negative reputation of Shariah scholars add more pressure to the situation.

5. *Liquidity Risk*

Liquidity risk is associated with sukuk if there is lack of intra-bank lending because due to Shariah restriction on trade of debt and other securities and prohibition of riba, sukuk issuer cannot resort to the lending from central bank. While traditional financial institutions have various instruments to manage their liquidity, sukuk remains one of very few options available of IFIs. The sukuk structure are exposed to liquidity risk as they are inadequately structured combined with insufficient liquidity in the secondary market (Ali, 2008). In order to develop liquid secondary market, government should become active in issuing Sukuk with issues representing variety of maturity, types and risk baring.

6. *Asset Related Risk*

Shariah requires all sukuk issues to be backed by tangible assets that is able to provide attractive returns. But the identification of appropriate asset is difficult, more so in non-Muslim countries due to the lack of clear understanding of Halal and Haram. Real estate has been the most commonly used asset for sukuk issue but recent economic crisis has changed the way things are being done. There is also the risk of loss of an asset which can affect both issuer and investor.

Shariah requirements are specified during the issuance of sukuk to ensure investor confidence given the competitive nature of the market as the difficulty of designing the appropriate sukuk structure coupled with the demands and requirements of the Shariah can significantly add to the legal costs and time taken even before the finds are raised (Ali, 2008).

7. *Regulatory Risk*

According to Goud (n.d.), one of the problems facing sukuk market is the absence of proper legislative base, especially for cases of possible default. Commonwealth law is the most common basis of sukuk contract because it is more established than local legislation in many countries and there is a possibility to obtain higher grading. According to Al-Amine (2008), solution for the problem can be achieved through standardization of Islamic financial contracts.

8. *Staff Related Risk*

The requirement of dual expertise in both conventional and Islamic rules have created an absence of specialists in the area of Islamic finance. This situation allowed conventional bank to issue sukuk as eight of top ten sukuk arrangers are conventional banks. In cases where sukuk is issued by someone with conventional background, there is always a possibility that such arrangement will not be able to satisfy all Islamic regulations.

9. Credit Risk

One of the most common type of sukuk risk is credit risk that happens due to the inability of the debtor to repay the financing amount when it becomes due and incases of delay or default in the payment of financing amount, the value of asset is reduced. Salam sukuk contracts are exposed to the risk that commodity will not be delivered in time or according to the arrangement.

10. Operational Risk

Operational risk involves an event or incident that occurs that causes a negative consequence to the operation of a project. Ineffective use of related tools and techniques, low quality in design, poor supervision and planning can all result in operational risk of a sukuk issue.

11. Institutional Risk

Institutional risk can occur for sukuk issue due to the rigidity of current Islamic financial infrastructure. Ali (2008)points out that the lack of certain features like non - existent inter-bank money market, lack of hedging and financial engineering process, non - uniform accounting practices, lack of regulatory standards and like can trigger institutional risk.

12. Capital Risk

Capital risk can be related to the lack of knowledge of Islamic financial techniques among the conventional banks who are eager to get a piece of the Islamic capital market. The lack of human capital among the Islamic financial institutions are allowing the conventional counterparts to offer sukuk issue through their Islamic wing which lack proper Shariah guidance.

13. Coupon Payment Risk

Delay in coupon payment or failure to pay by the obligator increased coupon payment risk. Any delayed coupon will be subject to specified payment amount that will be subject to specified Special Purpose Vehicle (SPV). Such accumulated funds are recommended by Shariah board to be donated for charitable purpose.

Sukuk Risk Management

Risks are uncertain future events that could influence the achievement of the financial institution's objectives including its strategies. There are boundaries that are more complex and difficult to manage risk in Sukuk compared to conventional bonds as everything must be in line with Shariah compliance. The Islamic principles that need to be followed when enter into instrument are asset backed transaction, ownership of asset, risk depends on real asset value, riba and gharar[2] free transaction, real investments and no use of speculation and no open interest.

In term of risk management for conventional theories, there are two main strategies that have been used which are diversification and hedging. Diversification is a very crucial strategy in minimizing Sukuk risk but it can be a problem for Sukuk market because not all market follows the rules of Shariah. Default risk can be reduced and managed through diversification, they argue that managing Sukuk portfolio requires knowledge and special know-how in both shariah and muamalat[3]. As it is still at its adolescence age, the world still lack of expertise in this area thus exposes the Sukuk framework to a higher credit risk. Some measures can help in improving Sukuk market efficiency and reduce its risks and one of them is by exploring diversification of Sukuk issues in term of their maturities, geographical locations and sectors of industry".

Hedging is another risk management strategy introduced by conventional theories. The word "hedge" means making an investment to reduce the risk of adverse price movements in an asset where it normally taking an offsetting position in a related security such as future contract. Hedging mainly depends on using derivatives which mostly are clearly prohibited by Shariah scholars but he then adds that "some Shariah scholars have taken the view that certain hedging arrangement may be allowed, provided that the instrument itself is structured in a Shariah compliant manner.

Fixed and floating rates can be used reduce the funding costs and thus raise the overall competitiveness and ultimately manage credit and market risk. Interest rate derivatives are the most commonly used risk management tool in the global market. But the prohibition of interest in Islamic finance makes the need for derivative instrument redundant. Sukuk will not be able compete in the traditional financial market by ignoring the use of financial engineering and will have to come up with new tools that is approved by Shariah.

Neftci & Santos (2003) identifies three opportunities to expand the scope for analyzing embedded bond options that can give protection to investors against Gharar and include the price stabilization properties of bonds, replacement of interest rate based derivatives market and introduction of embedded option bond to the government of both developed and emerging markets.

The price stabilizing properties identified by Merton (1995) and Neftci & Santos (2003)can be implemented to reap the convexity gains of trading in highly volatile emerging markets. Puttable and callable structures provides the benefits of a sound economic structure but there is always a possibility that traders of such securities will try to exploit the price volatility of the underlying bond.

Sukuk issuers can learn from the current advancements of the conventional bond market and try to adapt some techniques to the existing sukuk structure to make it more practical and competitive. Sukuk structures can be benefited by adapting the premises of these instruments because these instruments contain embedded options and allows conversion of debts into real assets and usufructs which is permitted in Shariah.

Sariah guidelines do not allow the sale of debts but allows the exchange of debts for real assets, goods and services and thus provides the opportunity of an exchange of debts against real assets and usufructs which can be added as an embedded option for the settlement of debts and if this happens then several risks such as liquidity risk, reinvestment risk, credit risk, interest rate risk and foreign exchange risk can be minimized.

Discussion

Sukuk can be a good replacement of conventional bond but it needs to remove some criteria which is not permissible under Shariah. Sukuk Structure need to be developed further to fulfil the Shariah Compliances. Some issues are identified which are affecting existing Sukuk. Firstly, sukuk should not follow the interest rate benchmark (LIBOR); secondly, sukuk must be real transfer of ownership; thirdly it must be based on risk sharing principle and finally transparency in the contract and lastly equal counter value. In order to improve the structure of the Sukuk it must include: Iwad[4], fairness and equality, ownership of the asset, risk sharing rather than risk transferring and remove the Riba based structure or use of benchmark of the profit (LIBOR). Asset backed Sukuk is more Shariah Compliant which has full potential to replace conventional bonds.

The conventional bonds are structured on the basis of debt while Sukuk are equity based instruments. Which method of financing should be considered, is a matter of choice and whether the bond issuer and/or bondholder would like to benefit from the growing market share of the religiously conscientious financial market. In order to establish Sukuk as a compatible replacement of conventional bond, there is a need to be tackle with the existing risk associated with the Sukuk which will motivate more investors in this Islamic financing product and foster the growth of Sukuk in the world.

Conclusion

The government bond is chosen by many investors as it is safe and liquid. But sukuk provides a better return and thus becoming more popular around the world. Besides, Sukuk can play a vital role in the social and economic development of a country. But the growth opportunities of Sukuk products and related market is being hampered by various types of risks associated with those products. This paper focused primary on the different types and aspects of Sukuk risk to make sure that investors become aware of what they are getting into. The first step in eradicating a problem it to find the root of the problem and it is suggested that more research on the factors that trigger the risk of sukuk should be initiated. In order to establish an efficient Sukuk market, regulators must develop standards and enforce them to ensure transpierce and accountability. Sukuk has the inbuilt Islamic mechanism that will lead it to success only if it is nurtured at the early stage of its development.

Notes

Shariah is an integral part of Islam and often defined as 'Islamic law'.

1. Gharar is generally prohibited under Islam, which explicitly forbids trades that are considered to have excessive risk due to uncertainty.
2. Muamalat refers to commercial and civil acts or dealings under Islamic law.
3. Iwad refers to the concept of counter value

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