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عنوان المداخلة:

Risk management of Sukuk Islamic bonds

Abstract:

The last decade witnessed a wide spread in issues of sukuk Islamic bonds, it has been growing at an average of more than 25 % per year. As the sukuk market continues to develop new challenges arise. Among these challenges risks underlying sukuk , these risks encounter vary according the structure of eache type of sukuk. The managment of risk associated with sukuk is a matter of great importance. The objective of this paper is to review Risk management of Sukuk Islamic bonds. In section one provides an introduction to Sukuk Islamic bonds and the difference between sukuk and conventional bonds, section two it will mention the different types of sukuk structure. In section three we undertakes risks facing Islamic finance. Section four attempts to explain risks underlying sukuk. Section five contains tools used to manage sukuk risks. Finally Section six provide a conclusion.

الملخص:

شهد العقد الأخير انتشارا واسعا لإصدار الصكوك المالية الإسلامية، حيث بلغ متوسط معدل نموها السنوي أكثر من 25% ، ومع استمرار سوق الصكوك في التوسع والنمو برزت تحديات عديدة لهذه الصناعة الواعدة، ومن بين هذه التحديات المخاطر التي تتضمنها هذه الصكوك، تختلف هذه المخاطر التي يمكن مواجهتها وفقا لكل نوع من الصكوك، ما يجعل قضية إدارة هذه المخاطر تكتسي أهمية بالغة جدا ، لذلك تسعى هذه المداخلة لاستعراض كيفية إدارة مخاطر الصكوك المالية الإسلامية، وذلك من خلال التطرق إلى مقدمة حول هذه الصكوك والفروق الموجودة بينها وبين السندات التقليدية في المحور الأول، ويستعرض المحور الثاني الأنواع المختلفة لهذه الصكوك، في حين يتطرق المحور الثالث إلى المخاطر المختلفة التي تواجه المالية الإسلامية بصفة عامة والمحور الرابع يتناول المخاطر المتعلقة بالصكوك الإسلامية، في حين يتطرق المحور الخامس إلى كيفية مواجهة المخاطر المختلفة للصكوك المالية الإسلامية والطرق المستخدمة في ذلك، وأخيرا يكون المحور السادس عبارة عن خاتمة.

introduction

The Islamic banking and finance sector is increasing its valuable market in the global finance industry, day by day. Sukuk is the most growing part in the Islamic capital market and as strong as its name and bright image. The last decade witnessed a wide spread in issues of sukuk Islamic bonds, it has been growing at an average of more than 25 % per year, sukuk brings along with it some major risks such as, default risk, regulatory risk, credit risk, liquidity risk, market risk and syariah compliance risk. So Sukuk are required more expertise and vigilance from the financial manager in order to manage its risks effectively.

1- introduction to Sukuk Islamic bonds and the difference between sukuk and conventional bonds

1-1 What are Sukuk

An Islamic financial certificate, similar to a bond in Western finance, that complies with Sharia, Islamic religious law. Because the traditional Western interest paying bond structure is not permissible, the issuer of a sukuk sells an investor group the certificate, who then rents it back to the issuer for a predetermined rental fee. The issuer also makes a contractual promise to buy back the bonds at a future date at par value.[1]

Sukuk[2] investments represent a distinct class of securities issued by sovereign and corporate entities. They are investment certificates with both bond and stock-like fea-tures issued to finance trade or the production of tangible assets. Like bonds, sukuk have a maturity date and holders are entitled to a regular stream of income over the life of the sukuk along with a final balloon payment at maturity. However, sukuk are asset-based rather than asset-backed securi-ties, with the underlying asset being necessarily Shari'a-compliant in both nature and use. The eli-gibility of sukuk rests on identifying an existing or a well-defined asset, service, or project capable of being certified by a third party, and for which ownership can be recorded in some form. Sukuk holders might be responsible for asset-related expenses, and the sale of sukuk results in the sale of a share of an asset. Bonds, in contrast, are pure debt obligations issued to finance any activity and whose value rests on the creditworthiness of the issuer. Sukuk prices can vary both with the credit-worthiness of the issuer and the market value of the underlying asset. However, while sukuk and shares of stock are similar in the sense that they represent ownership claims and that the return on both investments is not guaranteed, Sukuk must be

[1] http://www.investopedia.com/terms/s/sukuk.asp

[2] **sukuk** (Arabic: صكوك, plural of صك Sakk, "legal instrument, deed, check") is the Arabic name for Financial certificats, which derives from a Persian term meaning "to strike one's seal on a document.

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related to a specific asset, service or project for a period of time. Equity shares, of course, represent ownership claims on the whole company with no maturity date.[3]

1-2 History of sukuk

In classical period Islam, Sakk (sukuk)—which is cognate with the European root "cheque" from Persian '(چک) pronounced check'—meant any document representing a contract or conveyance of rights, obligations or monies done in conformity with the Shariah. Empirical evidence shows that sukuk were a product extensively used during medieval Islam for the transferring of financial obligations originating from trade and other commercial activities.

The essence of sukuk, in the modern Islamic perspective, lies in the concept of asset monetization—the so-called securitization—that is achieved through the process of issuance of sukuk (taskeek). Its great potential is in transforming an asset's future cash flow into present cash flow. Sukuk may be issued on existing as well as specific assets that may become available at a future date.[4]

In the pre-history, Sukuk investment was not yet known. Sukuk investments include as a new product among the economy world, while for the emergence of the idea to create sukuk is the needs of the community both among the Government and the individual communities as means of funding sources to cover the deficit and boost the economy. In the past in order to realize that goal, each party was forced to use debenture as a source of funding. The debentures are loans collected by the Government from each individual by offering widely, with the agreement of loan repayments plus interest within the time frame agreed by both parties.
Bonds are a document of long-term debt with worth of money. The purpose of the issuance of state bonds is to attract capital from investors. Briefly, bonds are debt but in the form of security. "Issuer" is bonds borrower or debtor in this case is the Government, while the "holder" of the bond is a lender or creditor and "coupon" bonds are loans interest that has to be paid by the debtor (State or Government) to the creditor. With the issuance of these bonds will

[3] Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, Do markets perceive sukuk and conventional bonds as different financing instruments? Bank of Finland, BOFIT Institute for Economies in Transition 2011, p 7-8.

[4] http://en.wikipedia.org/wiki/Sukuk

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be possible for the issuer to raise long term capital venture with funding from outside of the company.

The scholars agreed that the transaction is forbidden in Islamic law, the Islamic Fiqh Council in Jeddah established law No: 60 (11/6) in the sixth conference held in Jeddah in 1410/1990 concerning prohibition of these bonds. The decision reads: Bonds represent a commitment to pay certain amount with interest or use other terms, prohibited by Islam either in buying or trading for it is included in the loan-based (interest). Therefore, contemporary scholars and Muslim economists seek a suitable alternative to the forbidden bonds, and raise the idea in the first scientific conference of Islamic economics in 1976 in Dr. Sami Hamoud note entitled "Muqarada bonds", including the establishment of Islamic banks in Jordan. Then, once submitted to the Ministry in Jordan, they were trying to use this idea to reconstruct the Waqf lands. The idea was also offered to the Islamic Fiqh Council in Jeddah at the fourth session in 1988, and concluded the unified vision and legitimacy standards of sukuk Muqarada.[5]

The *Fiqh* Academy of the *OIC* in February, 1988, legitimized the concept of a *Sukuk*, by ruling that subject to proper legal documentation:

_ any collection of assets can be represented in a written note or bond; and

_ that this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts.[6]

Since then, Muslim countries around the world began to build bright ideas include the idea of sukuk investments to meet their budget deficits and increased public spending, also build vital installations. Among countries that developed this idea is Malaysia, Sudan, Pakistan and Bahrain. Indonesia in early 2009 has issued sukuk for the first time, then followed by the Hong Kong and Britain, from which it can be concluded that the idea of Islamic investment sukuk can be accepted by all people, especially after the global financial crisis.[7]

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[5] Ria Agustina Tohawi , Sukuk: Investment based on Shariah, Article avalaible on the site: http://amuslima.com/new-noteworthy-islam/sukuk-investment-based-on-shariah/

[6] Ghazal Zahid Khan, A comprehensive study of the International Sukuk market; Sukuk report; 1st Edition, available on this site: W W W . I I F M . N E T .

[7] Ria Agustina Tohawi, **op-cit.**

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1-3 the difference between sukuk and conventional bonds

The most prominent characteristics of conventional bonds may be summarized as follows:

Table 1: Sukuk versus Conventional Bonds

	Conventional Bonds	Sukuk
Asset ownership	Bonds don't give the investor a share of ownership in the asset, project, business, or joint venture they support. They're a debt obligation from the issuer to the bond holder.	Sukuk give the investor partial ownership in the asset on which the sukuk are based.
Investment criteria	Generally, bonds can be used to finance any asset, project, business, or joint venture that complies with local legislation.	The asset on which sukuk are based must be sharia-compliant.
Issue unit	Each bond represents a share of debt.	Each sukuk represents a share of the underlying asset.
Issue price	The face value of a bond price is based on the issuer's credit worthiness (including its rating).	The face value of sukuk is based on the market value of the underlying asset.
Investment rewards and risks	Bond holders receive regularly scheduled (and often fixed rate) interest payments for the life of the bond, and their principal is guaranteed to be returned at the bond's maturity date.	Sukuk holders receive a share of profits from the underlying asset (and accept a share of any loss incurred).
Effects of costs	Bond holders generally aren't affected by costs related to the asset, project, business, or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.	Sukuk holders are affected by costs related to the underlying asset. Higher costs may translate to lower investor profits and vice versa.

Source: Faleel Djamaldeen , Islamic Finance. ForDummies,http://www.dummies.com/store/product/productCd-1118233905.html

2-the different types of sukuk structure

- **Sukuk of ownership of tangible assets:** These Sukuk represent for their holders a common share in the ownership of assets that are either ascertained or established as a liability by

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description. This ownership grants these Sukuk holders the right in owning the funds realized from the sale of these assets or the sale of their usufructs.

- **Sukuk of usufructs:**

- These Sukuk represent for their holders a common share in the ownership of usufructs of ascertained assets (lease of ascertained assets) or assets established as a liability by description (forward lease).

-. They grant their holders the right in reselling the usufructs they represent through subleasing so that they can claim the rents from the sub-lessees.

- **Sukuk of lease of services:** These Sukuk represent for their holders a common share in the ownership ofservices that could be either ascertained or established as a liability by description (from a specific or nonspecific service provider). The provider of these services commits himself to provide them to others against a determined fee, whether in person or through what he undertakes to provide of facilities, means, equipment, devices or other things. Examples of these services include medical and educational services, means of transportation, legal or financial consultations and geometric designs. The fund mobilized through subscription is the purchase price of these services, whether for a certain period or a certain work. These Sukuk grant their holders the right of subleasing the service against a determined fee, which constitutes the return of these Sukuk.[8]

Sukuk al-Mudarabah: These types of Sukuk are certificates that represent projects or activities managed on the Mudarabah contract principle by appointing any of the partners involved in the deal as Mudarib for the management of the business. The parties involved in the Mudarabah are the Mudarib who is the issuer, the subscribers are the investors in the Sukuk and the realized funds are the Mudarabah capital. Moreover, the Mudarabah Sukuk holders own the assets of the Mudarabah and the agreed upon share of the profits belongs to the owners of capital and they bear any loss occurred.

Sukuk al-Musharakah: These are certificates of equal value issued for the mobilization of funds to be used on the basis of partnership, were their holders become owners of the relevant project or asset as per their shares that are part of their asset portfolios. These types of Sukuk can be issued as redeemable certificates by or to the corporate sector or to individuals for their rehabilitation, purchase of automobiles for commercial use or for the establishment of hospitals, factories,etc. Musharakah Sukuk is mode which can serve for the securitization of assets in big projects where huge amount of capital are required. The parties involved in the Sukuk al-Musharakah are the issuer who is the inviter to a partnership in a specific project or activity.

[8] DFM Standard For Issuing, Acquiring and Trading Sukuk, Shari'a and Fatwa Supervisory Board , Dubai 2013, p 9-10.

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The subscribers are the investors in the Sukuk partners in the Musharakah contract. The mobilized funds are the share contribution of the subscribers in the capital. And the certificate holders own the assets of the partnership and they are entitled to any profit realized.

Sukuk al-Salam: These types of Sukuk are based on Salam principle in which advance payment of price are made for goods to be delivered in a certain time in the future. It is certificates of equal value issued for the sale of mobilized capital that is paid in advance in the shape of price of the asset to be delivered in a certain time in the future. A Salam purchase canonward sell the Salam asset by another contract which is parallel to the first contract. Partiesinvolved in Sukuk al-Salam are the issuer who sells the Salam asset, the subscribers are the buyers of that asset, the mobilized funds which are the purchase price of the asset, which the Salam capital and certificate holders whom are the entitled to the Salam asset, the Salam price or the price of selling the on parallel Salam basis, if any.

Sukuk al-Istisna'a:These types of Sukuk are based on Istisna'a principle in which an agreement formanufacturing goods and allowing cash payment in advance and delivery at a certain time inthe future. In Istisna'a full ownership of the constructed item is immediately transferred upondelivery of the item to the purchaser, against the differed sale price that might also includeany profits which legitimately covers the cost of tying funds for the period of the repayment.

It is certificates of equal value and is issued with the aim of mobilizing funds required for producing a certain item or asset.[9]

General structure of Sukuk

Sukuk structure varies based on the type of contract it's based on. But however, there are three main parties involved in the Sukuk arrangement: the originator of the Sukuk who is the obligator, the issuer of the certificates who is the Special purpose vehicle (SPV) and the investors or the subscribers who invest on the Sukuk

[9] Khalid Abbasher Hassan, Comparison between Sukuk and Conventional Bonds: Value at Risk Approach, A dissertation submitted in partial fulfilment of the requirements for the degree of Masters of Science at University of Westminster, UK. 2012, p 9- 10.

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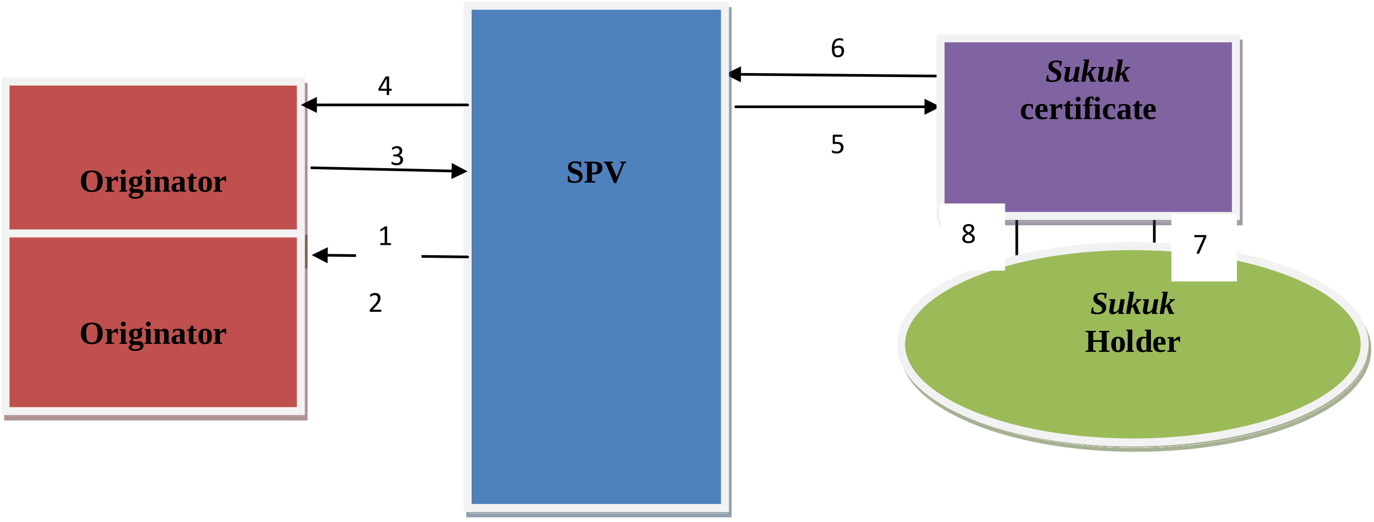
Figure (1) : outlines the basic general structure of a Sukuk arrangement.



1. The originator of Sukuk sells assets to be leased to the issuer or the SPV.
2. The originator receives payment for the assets sold.
3. The issuer or the SPV leases back the assets to the originator of the Sukuk.
4. The SPV then receives rent payments from the originator under a specified term contract.
5. The funds will be collected by the SPV from the issuance of the Sukuk certificates.
6. The rent payments collected by the SPV from the originator are utilized to disburse distributions on the Sukuk certificates.
7. The investors (Islamic and conventional) both secure the Sukuk certificates.
8. The investors receive cash payments periodically by the distributions from the issuer or the SPV funded by rental payments on the leased assets.[10]

3-risks facing Islamic finance

Risks are uncertain future events that could influence the achievement of the financial institution’s (i.e., Bank’s) objectives, including strategic, operational, financial and compliance objectives.[11]

Types of Risks Facing Islamic Institutions

According to Figure 2, the main financial and business risks faced by Islamic banks are:

· Financing Risks such as liquidity risk and credit risk.
· Market Risks such as foreign exchange risk, benchmark risk and securities price risk.
· Operational Risks such as people risk, technological risk and legal risk.

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[10] Ibid.

11 MohamadAkramLaldin, Risk Management in Islamic Finance, International Shari'ah Research Academy for *Islamic Finance (ISRA)*, P 5.

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In the section below, the major types of risks will be identified with possible solutions. After that, some of the hedging techniques will be discussed from an Islamic perspective.[12]

Stakeholders in Islamic financial institutions are generally more aware of risk than their counterparts in conventional firms are. As a result, they demand that their banks, mutual fund companies, and other financial organizations approach each transaction with an eye toward reducing risk. (Conventional customers and investors don't — and very likely can't — make such demands from their financial firms.)

This heightened awareness among stakeholders in the Islamic financial sector exists for a couple of key reasons:

- **Profit and loss sharing:** Islamic banking products (such as savings accounts) and investment products are based on contracts that call for profit and loss sharing between the customer and the institution.

  When a customer knows from day one that her principal will be returned and her investment rewarded only if the contract activity is profitable, she parts with her money fully aware that her decision carries risk, and she expects her investment partner (the financial institution in this case) to take certain precautions with her money.

- **Sharia-compliance:** To be sharia-compliant, Islamic financial transactions can't involve interest, gambling, speculation, or prohibited industries. Depositors and investors often seek out Islamic firms precisely because of this fact, but they're also aware that adhering to sharia principles constricts the firm in some ways. Sharia compliance amplifies certain financial risks . [13]

[12] Bilal A. Fleifel , RISK MANAGEMENT IN ISLAMIC BANKING AND FINANCE:THE ARAB FINANCE HOUSE EXAMPLE, A Thesis Submitted to the University of North Carolina Wilmington in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration, 2009, p 39.

[13] Faleel Djamaldeen, op-cit.

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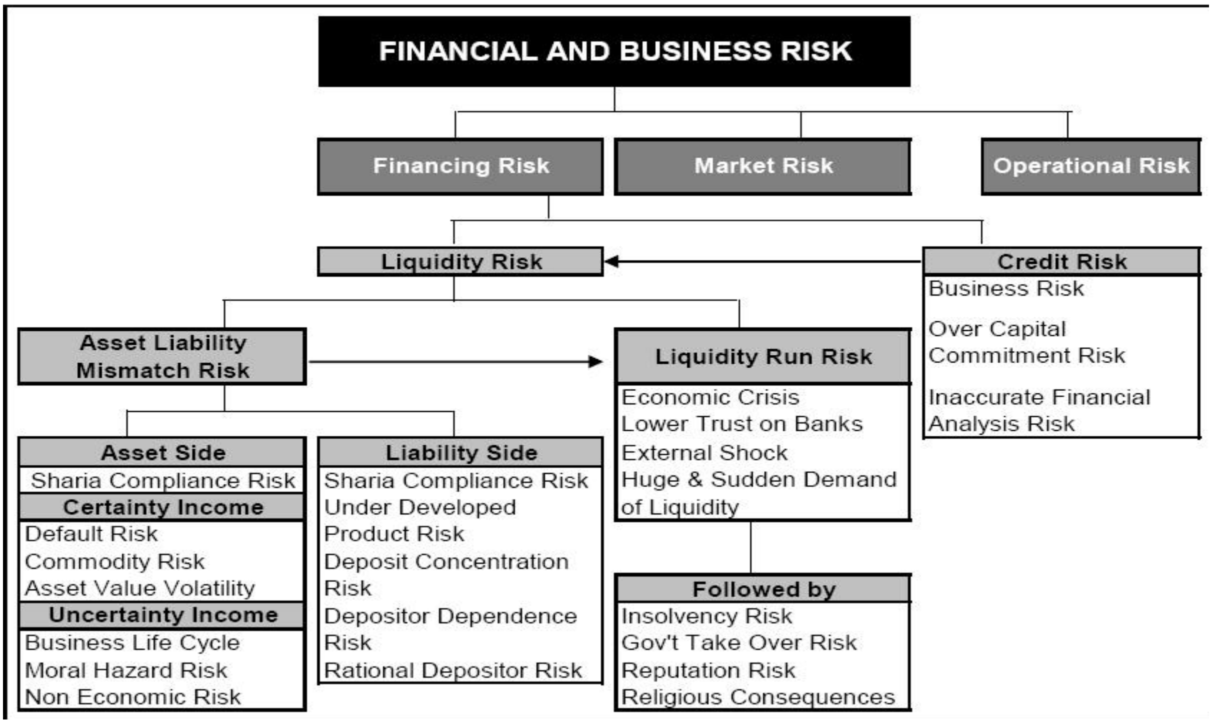
Figure (02) : the main financial and business risks faced by Islamic finance



4- risks underlying sukuk

Identification of risks associated with the Sukuk is the first and most importance step towards the better risk management. Unless one cannot able to properly identify the risks it is impossible to think about hedging or managing those.

Violation of the Islamic Shari'a Provisions

Since the sukuk are financial tools based on the Islamic Shari'a provisions, the violations of these provisions would lead to damages that vary according to the type of violation and the degree of its seriousness. It ranges from voiding the sak in its entirety to the cancellation of certain conditions. For example, when the underlying components of the sak are "Deyoun Murabahat" (debts to be paid back through fixed return notes) and "Usul Mouajara" (leased-assets based on variable return notes) the percentage of the debt should not exceed 33% of (the assets) underlying the sak throughout the lifetime of the sak so that its circulation would be permitted. If the debts were higher than this percentage, then the sak may not be circulated and thus becomes a weak liquidity (tool), or the ownership of the assets of "Sukuk Al-Ijara" becomes artificial.

For example, many of the Islamic institutions transfer the ownership of some of their customers' assets to a mortgage status and not for an actual sale. If these institutions bond these assets to a form of "Sukuk al-Ijara" or "Musharaka" or other kinds of available sukuk, these sukuk will become null and void because the institution had sold to the sukuk holders something that they do not own, which is among the prohibited sales in the Islamic shari'a. There are many ways of violating Islamic law, and each of the sukuk structures has its Islamic religious controls whose violations are considered among the risks for which the possibility of their occurrence, the ways to reduce them and the methods to address them must be studied[14]

Foreign exchange risk

Foreign exchange rate risk is applicable to sukuk with an underlying asset denominated in one currency and sukuk certificates issued in another currency. As suggested by Tariq (2007) in this case exchange-rate fluctuations can lead to a loss by investor or issuer. Since sukuk became international financial instrument it is difficult to avoid this type of risk. In some issues, like IDB sukuk issue, originator can guarantee investors protection from foreign exchange risk. The originator of sukuk can avoid this risk, by using several currencies in their issues. Tariq (2004) brings an example of Chinese sukuk issue, where one part of sukuk was issued in US Dollars and the remaining – in Euro.

One should also mention that sukuk can be used as an instrument to manage foreign exchange risk. Sukuk helps to diversify investment portfolios of Islamic financial institutions and can be used by foreign investors as a hedging instrument to manage exchange rate risk when issued in a domestic currency.[15]

Regulatory or Legal Risk

Everything needs to be regulated well in order to get benefit from it. This is true in the case of Sukuk and its market as well. Poorly, unregulated market results bad at the end2010). Sukuk market is not yet regularised to the full extent. No standardised and documented transaction structure of Sukuk is yet developed and the one which has developed so for is not uniformly accepted and adopted around the world*''Every region or even within the same region the Sukuk has its own structure for each and every issue''* So unregulated Sukuk market is very dangerous for all specially for investors and manager. It is a matter of great concern and high risk, which need to be addressed quickly. So this regulatory risk makes hurdles and

[14] The "Sukuk" Risks, *al-Sharq al-Awsat, London,* February 5, 2008. The article originally appeared in Arabic, and excerpts from the article were translated by the staff of www.memrieconomicblog.org

[15] Zhamal K Nanaeva, How risky sukuk are: comparative analysis of risks associated with sukuk and conventional bonds, Dissertation submitted in partial fulfillment of the degree of MSc in Finance and Banking, Faculty of Business, the British university in Dubai, May 2010, p 27.

confusions in the way of Sukuk market development. Even the person, who likes to buy Sukuk, is reluctant toinvest due to this unregulated Sukuk market.

Liquidity Risk

This is era of fast and dynamic world. Investors have the liberty to invest and disinvest as and when they wish. Liquidity is the key attractive feature of any successful financial instrument as in the case of traditional bond. Sukuk are exposed to liquidity risk, because there is negligible well-structured and sufficient secondary market for their trading For instance only Malaysia, UAE and Bahrain have the secondary market at local level for Sukuk trading but it is not in the case of rest of the world They are traded on local markets but this does not solve their liquidity problem. Presently most of the Sukuk are medium and long term and there is very small number short terms Sukuk in practise. *''Sukuk are at disadvantage due to the absence of its secondary market"* These all adds to the liquidity problems and the investors mostly have to keep these Sukuk certificates until their maturity. Sukuk cannot liquidise and has risk regarding its liquidity and investors are still worried to buy securities which are difficult to sell. Liquidity problem in Islamic financial institutions is due to number of the reasons like Small number of participants, slow development of Islamic financial instruments, no Shariah acceptable inter-bank market, absence of a liquid Islamic secondary market, no lender of last resort facilities, and different Shariah interpretation .[16]

Credit and Counterparty Risk

Credit risk refers to the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements. If the relationship involves a contractual arrangement than the counterparty risk, it would have probability that the counterparty retracts on the conditions of the contract. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inherent in Islamic finance are unique owing to the nature of Islamic financial instruments that become foundation of sukuk asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shari'ah considerations.

Operational Risk

There are numerous other risks specific to the operation of the sukuk. These risks mirror those existent in conventional bond markets and are operational in the sense that they are inherent to the structure of the issuances rather than the underlying Islamic principles.

Default Risk

Each prospectus has provisions for the termination of the certificate in the event of a default by the obligor. In case the obligor fails to pay the rentals on the Ijarah agreements that form the coupon payments, the certificate holder can exercise the right to nullify the contract and force

[16] Junaid Haider Muhammad Azhar, Islamic Capital Market Sukuk and its Risk Management in the Current, Master Thesis , StudentUmea School of Business Spring Semester, 2010, p50-51.

the obligor to buy back the assets. Furthermore, in the event that the obligor fails to repay the principal amount, thecertificate holder can exercise the right to take legal action and force the obligor to enter into debt rescheduling procedures.

Asset Redemption Risk

The originator has to buy back the underlying assets from the certificate holder. The principal amount paid may not be equal to the sukuk issue amount and, as a result, there is the risk that the assets may not be fully redeemed.

SPV Specific Risks

The Special Purpose vehicle is generally designated to be a standalone institute that is bankruptcy remote from the originator. However, there may be a notion of settlement risk involved with the SPV in that the originator will have to channel the payments through a clearinghouse. The certificate holders will then be reimbursed through the clearinghouse.[17]

Investor Specific Risks

The certificate holder is rendered to several risks pertinent to Sukuk structures. These are primarily regarding liquidity issues. The Sukuk structures, as welcome as they are in dealing with liquidity management issues in Islamic finance, are exposed to a liquidity risk because there currently does not exist a well structured and sufficiently liquid secondary market. The certificates are listed on several local markets but this alone does not signify their liquidity. The Sukuk certificates are medium to long term in maturity and their continued success will largely depend on their ability to evolve into highly liquid means of fund investment with adequate risk management mechanisms. As is the currently the case, most of the certificates tend to be held until maturity.

F. Risks Related to the Asset

The underlying assets of the Sukuk certificates are subject to numerous risks as well. Primarily, there is the risk of loss of the assets. These are minimal with regards to Ijarah assets of land parcels. However, in the case of equipment and large scale construction typifying some of the underlying IDB assets the risk of loss may not be so negligible. Nevertheless, Islamic finance has Shari'ah compliant provisions for insurance claims in the form of Takaful and these arrangements will have to be utilized to mitigate the risks of asset losses. Related to the asset risk as well is the need to maintain the structures of the assets. Proper maintenance will ensure adequate returns to the certificate holder. According to Shari'ah principles, the SPV will usually be required to bear the responsibilities on ensuring asset structure maintenance.[18]

5- tools used to manage sukuk risks

[17] Khalil Ahmed , Sukuk: De_nition, Structure and Accounting Issues, Munich Personal RePEc Archive, MPRA Paper No. 33675, posted 25. September 2011, p 8-9.

[18] Ali Arsalan Tariq , MANAGING FINANCIAL RISKS OF SUKUK STRUCTURES, A dissertation submitted in partial fulfilment of the requirements for the degree of Masters of Science at Loughborough University, UK, 2004, p 53.

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Market Risk-Managing Risks through Derivatives

We know that speculations and gambling are forbidden in Shariah. This condition creates the hurdle in the way of using traditional derivatives which are based on speculation. "Despite of derivative's importance in development of financial sector these are not currently used in the Islamic financial capital market and are generally forbidden". "What else remains with the Islamic financial capital manager to use for hedging purposes, perhaps nothing". This lack of Shariah compliance hedging instruments results in exposing risks and this is considered main obstacles in the way of the growth of Islamic capital market. "According to the head of Islamic division at Deutsche Bank, Hussien Hasan, Islamic financial is a sector at great disadvantage as compared to the traditional financial sector because of the lack of these hedging instruments". There is no recognised and standardized Islamic derivative instrument to manage market risks yet. And which are used to mage risks, not Shariah complied and is traditional derivatives. So risks are managed by other ways like lemmatizing the operation of the businesses, etc.[19]

Credit Risk Management

Sukuk default is an increasingly worrying phenomenon because it might reduce investors" confidence in this Islamic type of investment. Being the hub for the Islamic finance, Malaysia as the world's largest sukuk issuer might not escaped to this issue as well. Haider, J., & Azhar, M. (2011) bring a deep discussion on the matter of risk management in sukuk. The authors make a few recommendations so that defaults can be avoided in the future. One of it is syariah special credit rating, risk management consultancy firms and education and training institutions should be established in order to generate expertise in Islamic economics, finance and in sukuk. Aini N. and Rafisah (2011) discussed on the issues regarding sukuk default where they conclude that the defaults that occurred in the Middle-East countries which hold a high profile sukuk is a result of the economic difficulties and nothing to do with the validity of sukuk methodology.[20]

Sukuk Guarantees

Another on-going discussion among scholars is about permissibility of third party guarantees in some sukuk issues.[21] The meaning of guarantee in this context is guaranteeing the value of the Sukuk assets by the guarantor when they get destroyed or damaged, or when they fully or partially lose their value, without any misconduct, negligence or breach of the issuance conditions on the part of the guarantor. Nevertheless, the Sukuk manager shall guarantee the

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[19] Junaid Haider Muhammad Azhar, op-cit, p 55.

[20] Nurasyikin Mohd Noor, Nurasyikin Mohd Noor, Credit Risk Management for *Sukuk*: A Case Study of Debt-Based *Sukuk*, PROSIDING PERKEM VIII, JILID 3 (2013), ISSN: 2231-962X, p 1261.

[21] Zhamal K Nanaeva, op-cit, p 37.

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value of the Sukuk assets in these cases unless he proves that their occurrence was for reasons beyond his control, and which he neither could anticipate nor avoid.

The Sukuk manager's undertaking to buy the Sukuk assets at 'any value' does not amount to a guarantee of the Sukuk assets resulting thus in holding the Sukuk manager liable for these assets in cases of full or partial damage or loss. This is because the purchase undertaking binds its undertaker only when the assets promised to buy are existent at the time of its executing, while if the assets have been destroyed or damaged then the undertaking is not executable, because selling non-existing assets is not valid. However, if the assets undergo depreciation in their value, then the purchase undertaking may not be on the face value of the Sukuk, but only on a fair value or the market value.

The investment Sukuk manager is obliged to physically or constructively liquidate the Sukuk assets upon the maturity of the Sukuk as per the market practice, and to refund the capital as well as the realized profit unless he proves that the Sukuk assets have been damaged or have lost value for reasons beyond his control.

It is permitted for the holders of Istethmar Sukuk to obtain from a third party a binding promise over the purchase of the Sukuk assets at certain time or upon the maturity of the Sukuk. It is permitted as well for this promise to originate from the Sukuk manager so that he undertakes to buy the Sukuk assets described in the undertaking at one of the permitted values; the market value, the value agreed upon at the time of executing the purchase, the net assets value, a fair value or the value determined by the market experts at the time of executing the promise.[22]

Liquidity and secondary markets

The sustenance of any primary market depends heavily on the development of a sustainable and robust secondary market. Islamic savers and investors, like conventional ones, portray varying risk preferences and a secondary market should be developed to reflect this. Sukuk certificates are unique in that the investor becomes an asset holder and is directly tied in to the nature and functioning of the underlying asset pools. Sukuk certificate holders carry the burden of these unique risks.

Mirakhor (1995) contemplates the viability of an Islamic secondary market for tradable certificates. The primary concern of an Islamic secondary market is its marketability. All things being equal, a certificate holder would rather participate in a well structured and well regulated secondary market instead of trading in a poorly run market. By doing so, the investor's chances of liquidating his investments as efficiently as possible are enhanced. However, the marketability risk is closely tied in to other factors such as informational efficiencies as well as

[22] [22] DFM Standard For Issuing, op-cit, p 26.

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the number of traders in the market. The greater informational efficiencies are the better informed decisions investors can make about markets and the more accurate price transparencies will be. Also, higher number of traders implies a better chance of liquidating securities and helps reinforce access to more powerful market signals.

An important consideration to make with regards to Islamic secondary markets is the Shari'ah applicability of the trading involved in the exchanges. It is considered that the central bank or the security commissioner will have a pivotal role in mediating the interactions between the brokers and traders to lend adequate support and supervision to facilitate the functioning of markets. The optimal structure of an Islamic secondary market would be a dealer market where several groups of individuals will liquidate substantial proportions of assets into tradable securities. The central bank's role in such an arrangement would be to allocate adequate funds and supervision so as to avoid re-financing of debt generated by independent borrowers.[23]

Liquidity can be measured by the immediate access to a determinate amount of cash. The adequate mitigation of credit and pricing risks of assets has to be targeted in any formulated balance sheet management system. The success of the Sukuk structures in helping firms manage their liquidity will be contingent on their ability to develop into highly rated certificates with a unwavering overnight value. It is a positive sign that several of the prospectuses have been oversubscribed but the reality seems to be that these certificates are held to maturity even though they can be traded on listed stock exchanges

The main avenue for Islamic financial institutions to maintain high liquidity has been through back to back Murabaha transactions. Sukuks present an important progressive step in the pursuit of liquidity management but the absence of a structured inter-bank market proves a challenging hindrance as institutions cannot position their funds within a different range of short to long term investments. Warren (2004) identifies the existence a risk pyramid of investments for a reliable asset/liability management. Prior to the Sukuk issuances, Islamic financial institutions were faced with an indistinct situation to choose between a dearth of Shari'ah compliant, low return instruments and a world of non- Shari'ah compliant, high return investments. Consequently, almost every Islamic financial institution is built upon layers and different levels of Shari'ah compliancy. This will be a continuous phenomenon until Islamic

[23] Ali Arsalan Tariq ,op-cit, p61.

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finance can develop fully Shari'ah compatible inter-bank markets, liquid financial instruments and risk management mechanisms. [24]

Other Risks

Third part risk is managed by keeping one or more of the major Sukuk holders in the management of SPV who will take care of the interests of all the Sukuk holders including minors. Face value realization risk is currently managed byproviding guarantee to the Sukuk holders which is equal to face value of the Sukuk by theborrower that he will buy the asset or service at maturity date form the SPV at this predetermined amount. So at the maturity Sukuk holder will receive the guaranteed amount equal to the face value of the Sukuk outstanding to date. Profit or return payment are also guaranteed at a specific time with pacific predetermined rate. So this risk also overcomes by providing guarantee return payment
by the borrower in advance.

Conclusion

Sukuk has now become the strongest segment in Islamic finance. Sukuk have confirmed their viability as an alternative to conventional bonds, it faces numerous critical challenges that need experienced individuals and professional teams to solve. Creating and recognizing and standardizing Islamic derivative instrument to manage market risks, guaranteeing the value of the Sukuk assets by the guarantor when they get destroyed or damaged, Special assets management guidelines and standards should be developed and implemented all over the world which is based upon the Islamic teaching and principles world In order to make strong and stable Islamic capital market. Innovating new Sukuk structure which can be traded in the secondary market in accordance with the Shariah is also recommendable.

[24] ibid, p62.

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