

SUKUK STRUCTURE AND UNDERLYING RISKS: LESSON FROM MALAYSIA

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Abstract

The *sukuk* market has grown rapidly over the last few years in terms of size, numbers and sophistication. *Sukuk* provide sovereign governments and corporations with access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base. Most of the *sukuk* are structured based on *ijarah* contract, while others applied some various contracts such as *mudharabah*, *musharakah*, *salam* and *istisna'*. *Sukuk* are different from conventional bonds by some risks that each issuer and investor must take into consideration. There are a lot of issues and debates regarding *sukuk*, including the implication of underlying risks on its structure. The risks that *sukuk* encounter varies according to the structure of contract as well as underlying assets of the *sukuk*. This study will discuss on two types of *sukuk*, namely *sukuk ijarah* and *sukuk mudharabah*. The primary focus is to highlight underlying risks of these *sukuk* structures which may be different from conventional bonds. The identification of risks is vital for product development and serves as preliminary step towards innovation. In addition, the implication of risks in *sukuk* structuring is important for re-establish the credibility of *sukuk* within the Islamic finance industry. What is more important is for *sukuk* to sustain in the liberalized international economy.

JEL classification: G15, G29, G32

Keyword: Islamic finance; Malaysia; risk; *sukuk*

1. INTRODUCTION

The *sukuk* market has grown rapidly over the last few years in terms of size, numbers and sophistication. *Sukuk* has gain popularity in Malaysia since its first inception in 2002. *Sukuk* provide sovereign governments and corporations with access to the huge and growing Islamic liquidity pool, in addition to the conventional bonds. Most of the *sukuk* are structured based on *ijarah* contract, while others applied some various contracts such as *mudharabah*, *musharakah*, *salam* and *istisna'*.

Sukuk are different from conventional bonds by some risks that each issuer and investor must take into consideration. The risks that *sukuk* encounter varies according to the structure or underlying contract of the *sukuk*. For instance, the risks of *sukuk murabahah* differ from those of *sukuk ijarah*, *sukuk mudharabah* or *sukuk musharakah* respectively. The risks also vary depending on the underlying assets of these *sukuk*. Among the common risk is violation of *shariah* provisions, i.e. *shariah* non-compliance risk. Depending on the degree of violation, it ranges from voiding the overall *sukuk* to the cancellation of certain conditions. Other type of risk in *sukuk* is operational risk. Since *sukuk* structures must be based on underlying assets which the return on these *sukuk* originates, then risks of these assets also play an important role on the *sukuk* structures. Therefore, the implications of underlying risks on *sukuk* structure are among the prevailing issues in *sukuk* debates. Furthermore, in the wake of a series of high profile *sukuk* defaults in the GCCs, e.g. Investment Dar, Saad Group and Dubai World's Nakheel *Sukuk* in 2009, *sukuk* are alleged to have lost credibility as feasible and viable Islamic long-term project financing instrument (Raja Teh Maimunah, 2010a).

Given that much of the problems of *sukuk* structures that come into surface are to a large extent related to risks, this study will discuss the underlying risks in *sukuk* structures, specifically *sukuk ijarah* and *sukuk mudharabah*. The primary focus is to highlight the general and special risks surrounding *sukuk* which are different from conventional bonds. In addition, by closely examining the risk for both *sukuk* structures, which represent debt-based and equity based instrument subsequently, the study will also bring to light the main differences of both structures from risk management point of view. The identification of risks is vital for risk mitigation mechanism in *sukuk* as well as for product development and serves as preliminary step towards innovation.

The study contributes to literature by providing comprehensive discussion on underlying risks of two *sukuk* structures, i.e. *sukuk ijarah* and *sukuk mudharabah*. Identification of risks in *sukuk* structures is important for the reason that the use of financial products in conformity with *shariah* principles causes special issues for supervision and risk management. Efficient risk management in Islamic capital market instruments has assumed particular importance as they try to cope with the challenges of financial liberalization. What is more important for *sukuk* are to sustain in the international market and to re-establish the credibility of *sukuk* within the Islamic finance industry.

The rest of the paper is organized as follows. Part 2 summarizes overview of *sukuk* development specific to Malaysian Islamic capital market. Part 3 describes research design. Part 4 discusses findings on *sukuk* structure and underlying risks, and Part 5 concludes.

2. RESEARCH BACKGROUND: SUKUK DEVELOPMENT

2.1 *Sukuk*

Sukuk are one of financial instrument for raising funds and are a vital vehicle for resource mobilization, whether in the public or private sector. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) refers *sukuk* to investment products. It can be defined as “certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity” (AAOIFI, 2002). Based on the definition, *sukuk* can be further defined as a commercial paper that provides an investor with ownership in an underlying asset. It is an asset-backed trust certificate evidencing ownership of an asset or its usufruct. It has a stable income and complies with the principle of *shariah*. Unlike conventional bonds, *sukuk* need to have an underlying tangible asset transaction, either in ownership or master lease agreement.

Sukuk can be of many types depending on Islamic contracts or principles of financing and trades used in the structuring process. AAOIFI has issued standards as guidelines for 14 different types of *sukuk*, which can be classified as tradable and non-tradable, ranging from short-term purchase financing to complex funding of real estate development and industrial project financing. However, the most common principles used in *sukuk* structuring are *mudharabah*, *musharakah*, *murabahah*, *ijarah*, *salam* and *istisna'*.

2.2 Risks in *Sukuk*

Risks are an essential part of financial instrument. Increasing complexity and convergence of financial activities has resulted in diversity of risks. The Islamic financial industry has different orientation towards risks. The risks are more aligned on the basis of contract types, as a result of the special structuring of the contracts in its products (Akkizidis & Khandelwal, 2008).

Sukuk are distinct from traditional bonds by some risks that each issuer and investor must take into account. In economic terms, there are three common types of *sukuk*; namely fixed-income *sukuk*; asset-backed *sukuk* (ABS); and hybrid *sukuk* (Zawya, 2009). Risks in the first *sukuk* are very much to do with credit risk of the originator/obligor (firm), whilst risk in the ABS is related to performance of the underlying asset of *sukuk*. Risk for the last *sukuk* originates from combination of originator's credit risk and underlying asset. Therefore, *sukuk* should not be treated as debt instruments which are similar to bonds, and which underlying assets as well as their contractual structures to transfer funds from investors to *sukuk* issuers. By treating *sukuk* alike bond will lead to improper assessment of *sukuk* and, as a result, the risks will not be addressed appropriately. The risks that the *sukuk* encounter varies according to their structure and depends on the underlying assets of *sukuk*, be it tangible or intangible.

2.3 Studies on Risk in *Sukuk*

Of all rapidly growing Islamic capital market securities, none are gaining in popularity as much as *sukuk*. The study on *sukuk*, in particular the underlying risks of *sukuk* are an interesting subject matter and offers room for further research. At present, only a few studies on this specific issue since *sukuk* are relatively new capital market instruments as compared to conventional bonds. Significant ideas are mostly put forward by Tariq

(2004) and Tariq and Dar (2007). Tariq (2004) discusses on various risks in *sukuk*. One of the risks is *shariah* non-compliance risk that refers to the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with *shariah*. There could be several such instances of wilful or innocent breaches. The dissolution clauses of the *sukuk* prospectus define events that will make the *sukuk* deed null and void due to *shariah* non-compliance. In this case, he discusses the possibility of extending the functions of embedded options to fit the needs of *sukuk* certificates and *shariah* considerations. This facility provides a debt structure framework that helps replicate the functions of traditional instruments and in turn benefit from the convexity gains of these instruments.

Tariq and Dar (2007) again make an effort to identify the underlying risks of *sukuk* structures and suggest some possible methods of mitigating the risks. Meanwhile the underlying assets of the *sukuk* certificates are subject to few risks, e.g. risk of loss of the assets. *Sukuk* structured based on fixed rates are exposed to rate of return risk in the same manner as fixed-rate bonds are exposed to interest-rate risk. The rise in market interest rates leads to a fall in the value of fixed-income *sukuk*. In the event of a divergence between the unit of currency in which the assets in the *sukuk* pool are denominated and the currency of denomination in which the *sukuk* funds are accumulated, the *sukuk* investors are rendered to an exchange-rate risk. Some of the issues on this matter have also been addressed by a few scholars. Rosly and Sanusi (1999) criticize the application of *bay' al-'inah* and *bay' al-dayn* in *sukuk* in Malaysian practice which lead to *shariah* non-compliance risk. Those contracts were not allowed by the majority of *fuqaha'*, especially Shafie on the premise that it is similar to back-door interest and could be risks for *sukuk* to be accepted by different Islamic thought.

There are also issues addressed by Al-Amine (2001 & 2008) regarding the possibility of reselling *sukuk salam* before taking possession that might lead to *gharar* or *riba*. He also discussed the issue of benchmarking in *sukuk* that use London Inter-bank Offer Rate (LIBOR), which is similar to the conventional bonds benchmarking. Chapra and Khan (2000) identify various unique credit risks that are particular to Islamic finance including *sukuk* as one of the instrument. Khan and Ahmed (2001) identified that *salam sukuk* has unique basis of credit risks, while *sukuk musharakah* has high default risk.

The key to innovation of *sukuk* are to focus on pricing and risk characteristics. For sovereign, *sukuk* pricing could be based on real macroeconomic variables such as gross domestic product (GDP) growth rather than interest benchmarks. When GDP growth was high, government tax revenue would usually increase more rapidly. This would enable governments to pay a higher return to investors in their sovereign *sukuk*. Conversely when gross domestic product (GDP) growth was lower, government revenue would be lower, implying a reduced capacity to service debt and pay *sukuk* holders. In other words, *sukuk* holders would be taking on some of the sovereign risk (Tariq, 2004). By sharing risk with governments and reducing their obligations in times of difficulty, the risk of default would be reduced.

Sundararajan and Luca (2002) consider that non-existence of efficient institutional support increases the risk of *sukuk* as compared to traditional fixed incomes. Tariq (2004) find that the emergence of *sukuk* certificates as mechanisms of liquidity management presents a novel asset-backed securities structure that can set the foundation for supporting risk-management derivative instruments. Therefore, he suggests the development of *sukuk* and its derivatives such as embedded options as a good financial management in managing risks of *sukuk*.

2.4 Structure of *Sukuk Ijarah* and *Sukuk Mudharabah*

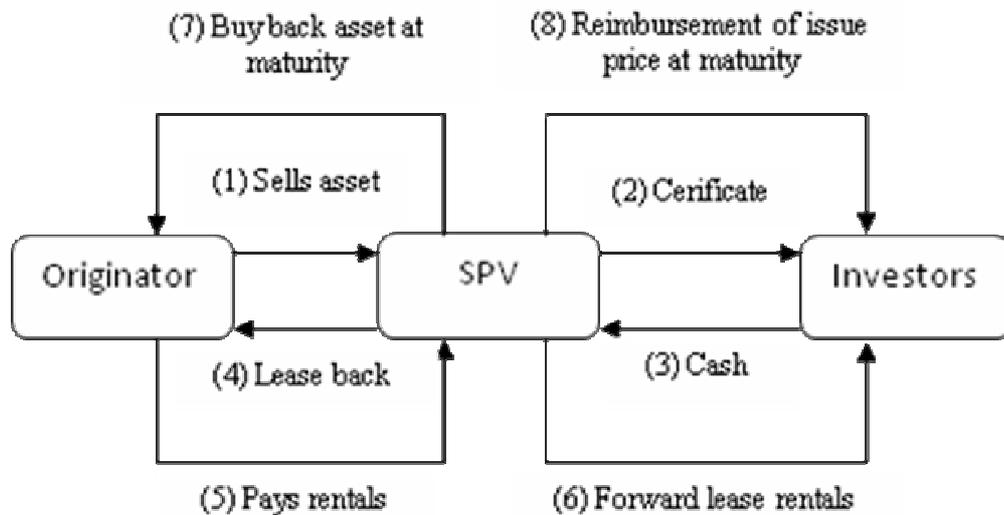
Sukuk can be classified into two types of financing, namely debt and equity-based. Based on these two classifications, various *sukuk* structures have been developed based on Islamic principle/contract over the decade. *Sukuk ijarah* is the most popular and widely used Islamic structure locally and internationally. *Sukuk mudharabah* is one of the simplest structures of *sukuk* given the fact that *mudharabah* contract is an age-old way of financing enterprises. Other types of *sukuk* are also playing significant role to help issuers and investors alike to participate in major projects according to their financing and investment needs.

2.4.1 *Sukuk ijarah*

Sukuk ijarah represents ownership of equal shares in a rented real estate or the usufruct of the real estate (AAOIFI, 2002). Basically, the *sukuk* owner has the right to own the real estate, receive the rent or disposes the *sukuk* at any time. *Sukuk ijarah* continue to prevail as the most popular manifestation of *sukuk* certificates due to their unambiguous *shariah* conformity and familiar leasing formula. The following are the common features of *sukuk ijarah* as outline by Nisar (2007):-

- a. Fully descriptions on contract are very much necessary and the assets being leased and the amount of rent both are clearly known by contractual parties at the time of the contract. This is very crucial to enable an asset or a building that is yet to be constructed, being leased by the time set for its delivery to the lessee.
- b. Predetermined rental in under *ijarah* must be in clear terms.
- c. As per *shariah* principles concerns, the owner will responsible on any expenses related to underlying assets and maintenance expenses related to its operation are to be borne by the lessee.
- d. SPV purchases the asset to enable them to issue *sukuk ijara*. The asset is then leased to third party for its use.
- e. *Sukuk ijarah* are completely negotiable and can be traded in the secondary markets.
- f. *Sukuk ijarah* offer a high degree of flexibility from the point of view of their issuance management and marketability.

Figure 1 illustrates the basic structure of *sukuk ijarah*.



Source: Abstracted from Wilson (2008).

Figure 1: Basic Structure of *Sukuk Ijarah*

ii. Steps involved in the *sukuk ijarah* structure:

- (1) The originator sells certain assets to special purpose vehicle (SPV) at an agreed pre-determined purchase price.
- (2) – (3) SPV will raise funds to finance the purchase of the assets through the issuance of *sukuk* and sell to investors.
- (4) A lease agreement is signed between SPV and the originator for a fixed period of time, where the obligator leases back the assets to lessee.
- (5) – (6) SPV receives periodic rentals from the originator. These are distributed among the investors i.e. the *sukuk* holders.
- (7) – (8) At maturity, the SPV sells the assets back to the seller at a predetermined value. This proceed will be used to reimburse the certificate holder at issue price.

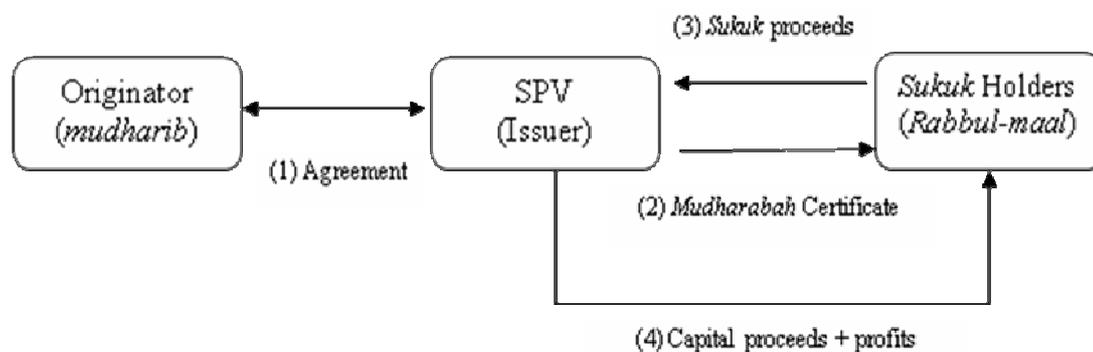
2.4.2 *Sukuk mudharabah*

This *sukuk* represent ownership of units of equal value in the *mudharabah* equity and are registered in the names of holders on the basis of undivided ownership of shares in the *mudharabah* equity and its returns according to the percentage of ownership of share (AAOIFI, 2002). The main purpose of *sukuk mudharabah* is to boost the public participation in big investment projects. In this structure, the capital provider is called *rabbul-maal* and the entrepreneur is called *mudharib*. In fact, the *rabbul-maal* is the owner of *sukuk mudharabah*. Nisar (2007) summarizes the general characteristics of *sukuk mudharabah* as:-

- a. *Sukuk mudharabah* represent common ownership and entitle their holders share in the specific projects against which the *sukuk* has been issued.

- b. The *sukuk mudharabah* contract is based on the official notice of the issue of the prospectus which must provide all information required by *shariah* for the *qirad* contract such as the nature of capital, the ratio for profit distribution and other conditions related to the issue.
- c. The *sukuk mudharabah* holder is given the right to transfer the ownership by selling the deeds in the securities market at his discretion.
- d. The originator who receives the fund collected from the subscribers of *sukuk mudharabah* can also invest its own fund and could get profit for the capital invested in addition to his share in the profit as *mudharib*.
- e. *Sukuk mudharabah* contract should not contain any capital guarantee from the issuer or the manager of the fund or a fixed profit, or a profit based on any percentage of the capital.
- f. It is permissible to create reserves for contingencies, such as loss of capital, by deducting from the profit.

Figure 2 illustrates the basic structure of *sukuk mudharabah*.



Source: Author's compilation (2010).

Figure 2: Basic Structure of *Sukuk Mudharabah*

ii. Steps involved in the *sukuk mudharabah* structure:

- (1) The originator entering agreement with SPV to raising fund in finance a project.
- (2) SPV issues *mudharabah* certificate that representing common ownership in the specific projects.
- (3) SPV received cash from the investor and pass it through to originator/*mudharib*. In this case, SPV and *mudharib* are two separate entities.
- (4) *Rabbul-maal* collects regular profit payments and final capital proceeds from project activity.

In the case of *mudharib* and project owner is two different entities, the *mudharib* hands over the completed project to the owner upon completion. Furthermore, the *sukuk* holders are given the right to transfer the ownership by sale or trade in the securities market at his discretion at maturity.

For the purpose of this study, *sukuk ijarah* and *sukuk mudharabah* are used as they represent debt-based and equity-based, allowing for significant comparison in terms

of structure and risk. This is very important and vital for industry development since there is lack of study on risks for both structures.

2.5 Development of *Sukuk Ijarah* and *Sukuk Mudharabah* in Malaysia Capital Market

Malaysia's Islamic capital market continues to show vibrant growth as can be seen from the ever-increasing size and diversity of products offered. For instance, Table 1 describes the issuance of both *sukuk ijarah* and *mudharabah* from 2007 to 2009. This is attributable to various factors including well-executed policies, facilitative regulatory environment, increasing numbers and sophistication of intermediaries that continue to push the frontiers in terms of product innovation as well as the existence of a complete, matured and well established Islamic financial system.

Table 1: Malaysia: *Sukuk Ijarah* & *Sukuk Mudharabah* Issuance (2007-2009)

<i>SUKUK IJARAH</i>				<i>SUKUK MUDHARABAH</i>			
No.	Year	Issuer	Size of Issues (RM mil)	No.	Year	Issuer	Size of Issues (RM mil)
1.	2009	Pengurusan Air SPV Berhad (* <i>Musharakah</i>)	20,000	1.	2008	Projek Lintasan Shah Alam Sdn Bhd (* <i>Ijarah</i>)	745
2.	2008	Dewa Ringgit Sukuk Limited	3,500	2.	2008	Matang Highway Sdn Bhd (* <i>Musharakah</i>)	70
3.	2008	Dura Pisifera Sdn Bhd	321	3.	2008	Muhibbah Engineering Berhad	130
4.	2008	Dura Pisifera Sdn Bhd	38	4.	2008	Muhibbah Engineering Berhad	400
5.	2008	TH Group Berhad	330				
6.	2008	Tadamun Services Berhad (* <i>Istisna'</i> & <i>Murabahah</i>)	1000				
7.	2008	Sepangar Bay Power Corporation Sdn Bhd	450				
8.	2008	Syarikat Borcos Shipping Sdn Bhd (* <i>BBA</i>)	370				
9.	2008	TSH Sukuk Ijarah Sdn Bhd	400				
10.	2008	Projek Lintasan Shah Alam Sdn Bhd (* <i>Mudharabah</i>)	745				
11.	2008	Aras Sejagat Sdn Bhd	500				
12.	2008	Stratavest Sdn Bhd	120				
13.	2008	Cosmo-Jupiter Berhad	600				
14.	2007	Tradewinds Plantation Capital Sdn Bhd	190				
15.	2007	Binariang GSM Sdn Bhd	3,150				
16.	2007	Menara ABS Bhd	1,100				
17.	2007	Al-Aqar Capital Sdn Bhd	300				

18.	2007	Alam Maritim Resources Bhd	500
19.	2007	Total Mobile Sdn Bhd	30
20.	2007	Total Mobile Sdn Bhd	150
21.	2007	Hijrah Pertama Bhd	2997
22.	2007	Pins Capital Sdn Bhd	150
23.	2007	Kuala Lumpur Kepong Bhd	500

Note: * = Combination issues.

Source: Abstracted from Securities Commission of Malaysia (2010).

3. RESEARCH DESIGN

The aim of this paper is to provide a conceptual understanding on *sukuk* structures. It also discusses underlying risks comprehensively, with Malaysian *sukuk* industry as a case study. This paper will follow qualitative research method. Data sources include observation, documents and texts (i.e. archival research), and the researcher's analyses on the subject matter. Written data sources include published and unpublished documents, company reports, reports, newspaper articles and others.

4. ANALYSIS AND DISCUSSION

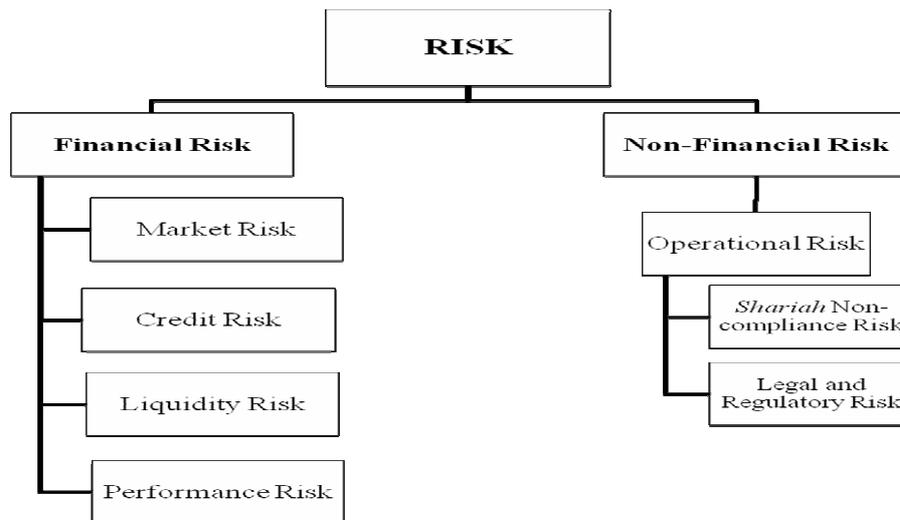
4.1 *Sukuk* Structure and Underlying Risk

Sukuk has been used extensively in financing for the last ten years. The complex structure of *sukuk* draws different reactions from the Islamic capital market participant as well as scholars around the world. Some structure of *sukuk* may approved by *Shariah* Board in one country but not in other countries. The continuous debate on *sukuk* structure has raise numbers of issues that contribute to the development of *sukuk* market. One of the significant issues is the underlying risk on *sukuk* structure. This issue might be overlooked as most of the debate focus on the form of *sukuk* itself.

Generally, the existence of risk must be accompanied with at least two possible outcomes and at least one outcome must be unfavorable. The presence of more than one outcome turn out the possibility of desired outcome deviates from the actual outcome (Vaughan & Vaughan, 2008). However, the concept of risk is ambiguous and can be interpreted into various ways. In Islamic perspectives, risk could be the possibility of any event or product that not comply with *shariah* principles and Islamic laws. Any activity that involves *riba*, *gharar* and *maisir* is prohibited under *shariah* principles.

Risk could stimulate innovation to improve certain process or product as well as to exploit the risk itself. Identifying the risk in Islamic financial instruments is essential as it could initiate the process of innovation. Thus, in this section the underlying risk associate with *sukuk ijarah* and *sukuk mudharabah* will be indentified. Generally, risk can be divided into two broad categories i.e. financial and non-financial risk. Financial risk is basically refers to any event that causes a direct financial losses, while non-financial risk may not contribute to financial loss directly but it could increase the severity of financial risk. According to BIS (2009), financial risk consists of market risk, credit risk and liquidity risk. However, for the purpose of this paper, the discussion of financial risk could be extended to other related risk such as performance and bankruptcy risk. Thus, risks that not fall under these categories can be classified as non-financial risk as illustrated by Figure 3.

Figure 3: Underlying Risk for *Sukuk Ijarah* and *Sukuk Mudharabah*



Source: Authors' compilation (2010).

4.2 Financial Risk

4.2.1 Market risk

Khan and Ahmed (2001) define market risk as the risk originating in instruments and assets traded in well-defined markets. In other words, it is a risk of losing money due to changes in market forces. Accordingly, the movement of government and economic policies are the core of the existence of market risk. As the market forces are very dynamic and volatile, market risk could be categorized into different type of risk. In this paper, we will focus on rate of return risk, foreign exchange rate and price or asset risk.

i. Rate of return risk

As far as *sukuk* concerns, interest rate risks can be considered as rate of return risks. Currently, most of the foreign denominated *sukuk* used conventional benchmark such as LIBOR as the reference rate for pricing purposes due to the unavailability of well established Islamic benchmark. Thus, the movement of LIBOR would affect the rate of return. Accordingly, Ariss and Saredidine (2007) accentuate that the movement of reference rate would affect the Islamic bank's expected rate of return and may affect its ability to meet its obligations.

For fixed rate *sukuk*, the exposure to rate of return risks is similar with the exposure of fixed-rate conventional bonds to interest rate risk (Tariq & Dar, 2007). This will lead the market value of *sukuk* to shrink as the interest rate rising. However, this situation may not always happen for *sukuk* as the holders may sell the *sukuk* certificate before maturity or hold it until maturity. For the first situation, Tariq and Dar argument may applicable as buying and selling price of the *sukuk* would be based on the market price. However, fixed rate *sukuk* are mostly held by big institution and they tend to hold it until maturity. Thus, Tariq and Dar argument may questionable. Usmani (2008) declares that most of *sukuk* issued today are guaranteeing the return of principal to the *sukuk* holders at maturity. In Malaysia, it is permissible to guarantee the principal invested. In this case, the movement of interest rate is irrelevant for the actual market value of *sukuk*.

Tariq and Dar (2007) also point out that the exposure of fixed rate *sukuk ijarah* to market return volatility is higher compare to floating rate due to its exposure for entire maturity.¹ The effect of rate of return risk on fixed rate *sukuk ijarah* is the opportunity cost rather than the effect on market value of *sukuk* itself. This opportunity cost refers to the chances to enjoy capital gain. Although *sukuk ijarah* represent ownership of equal share in the rented asset or usufruct of the asset, Wilson (2005) emphasizes on the *sukuk ijarah* holders whom only benefits from fixed periodical rental payment and not to capital gains that usually the main motivation for equity investment. As such, floating rate *sukuk ijarah* seem to be more exposed to the interest rate volatility as the holder will received varied rate of return for entire maturity based on the movement of reference rate i.e. LIBOR. Regardless of market value of *sukuk*, floating rate *sukuk ijarah* tend to be riskier as the interest rate change.

Under *sukuk mudharabah*, the certificate holders are only entitled for profit sharing and no provision of capital gain (Wilson, 2005). Rate of return is solely depending on the project performance i.e. the value of *sukuk* will increase should the project perform well and vice versa. In the event of a business loss, the loss shall be borne solely by the capital provider (*rabbul-maal*). As such, the investors are facing high risk of losing their money. In reflection to this issue, the Shariah Advisory Council (SAC) of Securities Commission of Malaysia allows *sukuk* issuers in Malaysia to apply third party guarantee on the capital invested under *muqaradhah/mudharabah*.² SAC also permits fee (*ujrah*) to be paid to guarantor.

ii. Foreign exchange risk

Basically, the exposure of all *sukuk* structure to foreign exchange (FOREX) risk is similar but the composition of asset in *sukuk* pool and the maturity could differentiate the level of exposure for each type of *sukuk* (Tariq & Dar, 2007). Unfavourable fluctuation of exchange rate causes currencies to be depreciated or appreciated and leads to greater FOREX risk exposure. In relation to the discussion on *sukuk ijarah* and *mudhabah* exposure to FOREX risk, it will focus on the underlying assets and *sukuk* tenure.

Underlying asset is the backbone to *sukuk ijarah* as the certificate issued to investors will be backed by this asset. *Ijarah* based is relatively more expose to FOREX risk compared to *mudharabah* due to the presence of asset into it structure. Furthermore, underlying assets under *sukuk ijarah* could generate returns in foreign currency and this cash flow could be affected by the currency fluctuation (Zaidi, 2007). In other words, *sukuk ijarah* is also exposes to the economic losses as a result of currency exchange movement. Accordingly, FOREX risk occurs when the currency of the underlying asset in *sukuk* pool deviates from the currency where *sukuk* fund are accumulated (Tariq & Dar, 2007). Diversified asset composition and diversification of return from underlying asset is crucial to reduce the impact of foreign exchange variation.

Petronas Global Sukuk (PGS) was the first *sukuk* listed in Bursa Malaysia (Bursa), a Malaysian domestic onshore stock exchange, under the exempt regime. It also listed in Labuan International Financial Exchange (LFX), the Malaysian offshore stock exchange, and the Luxembourg Stock Exchange. This USD1.5 billion *sukuk* was structured based on *ijarah* principle and was marketed in Abu Dhabi, London, Singapore, Hong Kong and

¹ Floating rate *sukuk ijarah* exposes market return volatility within the time of floating period, normally 6 months (Tariq & Dar, 2007).

² Shariah Board in Malaysia is known as Shariah Advisory Council (SAC). There are two SACs; SAC of Bank Negara Malaysia (BNM) for the money, banking & *takaful* (Islamic insurance) market, and SAC of Securities Commission (SC) for the capital market (including *sukuk*).

New York. As PGS widened its target market and reduce the dependency on local and Middle East investors, it diversified currency exposure and minimizing the foreign exchange risk.

Besides underlying assets, the tenure of both *sukuk ijarah* and *mudharabah* is factoring the level of exposure to the risk of foreign exchange transaction. Transaction risk is related to the time gap between entrance and settlement of the contract. As such, *sukuk* with longer maturity will create higher time gap and increase the expose to this risk compare to the shorter maturity. In fact, the exchange rate could fluctuate more often in long term. For example, Kumpulan Gutrie Berhad through its SPV, First Global *Sukuk* had issued two series of *ijarah* based *sukuk* (Series A and Series B) in 2001 with a total value of USD150 million. The maturity for both Series A and B was 4 and 5 years respectively. Although the underlying asset for both certificates were similar i.e. parcel of land, but the exposure of Series B to transaction risk is greater than Series A due to its maturity.

iii. Price/asset risk

Price or asset risk can be defined as a variation in value of the underlying assets. In other words, price risk is the differences between fair-market and reported values of the underlying asset. In fact, *sukuk ijarah* is vulnerable to price risk compare to *sukuk mudharabah* due to nature of *ijarah* structure that requires asset backing in the process of certificate issuance. The underlying assets especially tangible assets are likely to depreciate in the future and cause the asset values to fall below prevailing market values. The issuer is likely to face this risk as the underlying assets under *sukuk ijarah* will be bought back by the issuer at maturity. Any differences in value will be borne by issuer and the investor will get the principal as stated in the contract.

4.2.2 Credit risk

Apart from market risk, *sukuk* are also exposing to credit risk. Khan and Ahmed (2001) define credit risk as the risk that counterparty will fail to meet its obligations timely and fully in accordance with the agreed terms. It is also refers to the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements (Tariq & Dar, 2007). *Sukuk* credit rating is reflects to the credit worthiness of the underlying asset and the issuers of certificate. Generally, *sukuk* with good credit rating (e.g. AAA, AA) entails low credit risk. Basically, *sukuk* aresued in Malaysia must have at least one credit rating throughout the tenure of *sukuk* (SC & BNM, 2007). This is important to boost confidence level of *sukuk* investors as well as Islamic capital market participants.

As mentioned above, SAC allows third party guarantee on capital invested by *rabbul-maal* under *sukuk mudharabah*. Thus, the major credit risk faced by the *rabbul-maal* is the non-payment of profit share by the *mudharib* at specified time. Poor performance of project and asymmetric information problem may contribute to credit risk. Generally, asymmetric information occurs when *mudharib* access more information compare to investors and this situation may encourage to non-fully disclosure of information for the benefits of *mudharib*. It then exposes the *rabbul-maal* to another risk called accounting risk. Accounting risks can be defined as the possibility to manipulated profit purposely for the benefit of one particular party. According to Obiyathulla (2008), *mudharabah* or *musharakah* contracts are highly exposed to accounting risk. In practice, *rabbul-maal* does not monitor the operations of project they are invested in. As such, only the *mudharib* know the profitability of the project. According to Wilson (2005),

purchasers of *sukuk* securities have the right to information on the purposes for which their monies are to be allocated. Investors' right to access information must be stated clearly in the contract to avoid any dispute after the contract is enforced. As such, accountability and transparency of *mudharib* is vital to ensure the *maqasid al-shariah* (objective of *shariah*) is attained.

The holders of *sukuk ijarah* enjoy fixed periodical rental payment from the issuer for entire maturity of *sukuk*. In essence, *sukuk ijarah* facing credit risk in two occasions. Firstly, credit risk during the contract is enforced. Under *sukuk ijarah*, issuer is obliged to pay the specified rental at specified time to the *sukuk* holders. Failure to pay rental payment at specified time imposes credit risk. Floating rate of *sukuk ijarah* is greater expose to this risk as rise in reference rate would increase the burden of rental payment. As such, the possibility of issuer to delay the rental payment is relatively high. Should this occurs, the *sukuk* holders can exercise the right to nullify the contract and force the obligor to buy back the assets (Tariq & Dar, 2007).

Secondly, credit risk when the contract is matured. At maturity, the SPV under *sukuk ijarah* will sell the underlying assets back to the issuer at a predetermined price. The proceeds from this selling will be distributed among *sukuk* holders. However, credit risk could occur at maturity when issuer is unable to buy back the underlying asset at predetermined value. According to Tariq and Dar (2007), *sukuk* holders could exercise the right to take legal action and force the obligor to enter into debt-rescheduling proceedings.

Excessive credit risk could expose the originators to bankruptcy risk. It refers to the inability of the issuer to meet its short and long term financial obligations. This risk is significant should the originator confront with financial difficulties after the enforcement of the contract. In assessing the issues regarding to bankruptcy risk, the ownership on the underlying assets should be explained.

Under *sukuk ijarah*, ownership of the underlying assets is belonging to the investor through certificates issued by the special purpose vehicle (SPV). Nevertheless, this ownership is considered as an "interim basis" as it will expire at maturity. Furthermore, it refers to the undivided ownership of the leased assets and the cash flow arising from the assets. However, some questions related to the ownership and occurrence of sale should be addressed. First, does the actual sale occurs (i.e. name of investors are stated in master title)? Second, can the investors liquidate the assets in case of originator default? According to AAOIFI, asset ownership should be transferred in full from originator to investor and the investor should own the *sukuk* asset legally. In practice, actual sale of asset may not occurs due to the tendency of contractual parties to sign both contracts i.e. sell and lease back, buy back contract concurrently. In fact, most of the SPV are owned by the originator. Accordingly, Vicary (2010) highlights that if the investors are unable to dispose the asset in case of default, the underlying asset has no genuine role in *sukuk* structure. In this case, the structure of *sukuk* are merely a metaphor for the purpose of legitimacy under *shariah* law. Howladar (2006) insists that *sukuk* holders must own the beneficial title of the underlying asset to avoid the risk of "claw back".³ By owning the asset legally, *sukuk* investors are entitle to all rights on the assets including the right to liquidate the asset in the event of originator become insolvent.

Basically, *sukuk mudharabah* is used to finance specific projects with low to medium risk to attract more investors. In handling or managing a project, it is rendering the owner or the entrepreneur to speculative risk as it can be either profitable or

³ Claw back refers to the possibility that those assets may now be reclaimed by the administrator of the insolvent estate and will not be available to repay *sukuk* investors (Howladar, 2006).

unsuccessful. Under *mudharabah* structure, bankruptcy risk could happen due to the failure of the project or the *sukuk* issuer become insolvent. The former is clearly understood that *rabbul-maal* would borne the entire loss should the project does not perform well, but the *mudharib* will responsible for the losses due to it negligence, mismanagement and dishonesty. However, in the case of originator gone bankrupt, which lead to the failure of the project, could the investors claim against them to recover their investment?⁴

The presence of SPV is not compulsory for *sukuk mudharabah* but most of the issuer in Malaysia (or even worldwide) tends to use SPV for tax incentives purposes as well as the function of SPV to remote bankruptcy risk. Although, the originator owns the SPV⁵, its liability is limited to the capital invested in SPV and prevent the *rabbul-maal* to make claims against the originator in the event of insolvency. Therefore, the bankruptcy risk facing by the investor is solely on the performance of the project and not to the originator.

4.2.3 Liquidity risk

Liquidity concerns on *sukuk* are continuously highlighted by Islamic capital market participants. In order to be liquid, *sukuk* market needs a very large volume as well as a sufficient supply and demand. Accordingly, a seller would be able to find a replacement to substitute the old *sukuk* that they have sold. Generally, liquidity risk would occur when *sukuk* holders are unable to sell their certificate due to certain restrictions such as inactive secondary market. Inactive or lack of secondary market may prevent the maximization of *sukuk* mobilization in the industry and may confront with liquidity risk.

Secondary market for *sukuk* in Malaysia is relatively new with Petroliaam Nasional Bhd (PETRONAS) *Al-Ijarah Sukuk* was the first *sukuk* listed in Bursa in August 2009. This the result of the decision by Bank Negara Malaysia (BNM) and Securities Commission of Malaysia (SC) to allow debt securities and *sukuk* to be listed in Bursa by both listed and non-listed issuer under the provision of section 229(1) and section 230(1) of the Capital Market and Security Act 2007 (BNM & SC, 2009). Statistically, there are 12 *sukuk* listed under exempt regime⁶ in this bourse amounting approximately of USD18.8 billion as May 2010 (Raja Teh Maimunah, 2010b). In fact, as a largest *sukuk* market in the world, Malaysia has emerged as a leader in *sukuk* listing and Bursa has overtaken Nasdaq Dubai as the top listings exchange in the world for *sukuk* in 2009 (Malaysian Islamic Financial Centre (MIFC), 2010).

In Malaysia, both *sukuk ijarah* and *mudharabah* are allowed to be traded in secondary market. Currently, *sukuk ijarah* and *musharakah* dominate the *sukuk* listed in Bursa but most of the *sukuk* are traded over-the-counter (OTC) and supported by a settlement system operated by the Malaysian central bank (MIFC, 2010). For example, Sukuk 1Malaysia 2010 (based on commodity *murabahah*) was introduced in June 2010. This *sukuk* has 3-year tenure with 5% return per annum and can be bought and sold before the maturity. Investors can trade this *sukuk* at appointed agent banks⁷ with minimum sale/purchase of RM100 and in multiples of RM100. However, buy and hold

⁴ It is permissible by *shariah* law to establish reserves for contingencies but it only covers the shortfall of expected profits.

⁵ Most of SPV in Malaysia are owned by the originator.

⁶ Exempt regime means that the *sukuk* will not be quoted or traded on the exchange. It basically traded over-the counter. Under this regime, the issuer of *sukuk* or debt securities not necessarily listed company. Unlisted company is also allowed to issues this security.

⁷ List of agent banks can be retrieved from <http://www.bnm.gov.my/index.php?ch=255&pg=816&ac=839>.

culture does not signify the liquidity of *sukuk* especially *sukuk ijarah*. As *sukuk ijarah* offer high fixed return compared to conventional bond at similar rating and tenure holders, the holders tend to hold the certificate until maturity. Furthermore, most of the *sukuk* are held by large institutions and it may be inaccessible for the average private investors. This culture may prevent the mobilization of *sukuk* in the market.

Under *mudharabah*, the *rabbul-maal* has the right to sell the ownership at maturity in the securities market at his discretion. It is also permissible to dispose the *sukuk mudharabah* for entire maturity and the price would fully depend on the current project performance. As such, the value of *sukuk* could be above or below the par value.

4.2.4 Performance risk

Generally, performance risk can be defined as a situation where actual performance deviates from expectation. Performance risk could increase the severity of credit risk and as mentioned above, credit risk causes bankruptcy risk. Accordingly, performance risk is crucial in determining the survival of the *sukuk*. In relating to *sukuk* structure, both *sukuk ijarah* and *mudharabah* are facing performance risk but in different magnitude. The value of *sukuk mudharabah* is solely depends on the project performance. As such, its value could be above or below face value should it be disposed before maturity (capital invested is guaranteed in Malaysia). Under this structure, the investor is highly exposed to this risk as the investor will bear all the losses if the project is underperform.

In *sukuk ijarah* case, the performance of underlying asset does not affect the rental payment but the overall originator performance could affect the ability to pay the rental for the whole tenure of the *sukuk*. As the overall performance of the originator might be affected by any economic conditions, rental payment could be default. For example, the rising in interest rate (most *sukuk* use LIBOR as a reference rate) for floating rate *sukuk ijarah* causes the rental payment to increase. It gives an additional burden to the originator and might lead to delay in payment. Therefore, it is very essential for an investor to assess not only the underlying asset but also the originator before putting their money in *sukuk*.

4.3 Non-Financial Risk

4.3.1 Operational risk

Operational risk refers to the failure of the internal process, people and system that resulting in direct and indirect losses (Basel, 2001). The complexity of *sukuk* structure could be the main sources of operational risk. As such, it could increase the consequences of financial losses should it occur. Although operational risk could come from any sources, the discussion on this paper only focuses on *shariah* non-compliance risk and legal and regulatory risk.

i. *Shariah* non-compliance risk

Shariah non-compliance risk is one of the operational issues that has been debated continuously since the existence of *sukuk*. In fact, it is a major operational risk that is associated in *sukuk ijarah* and *mudharabah*. *Shariah* non-compliance risk refers to the possibility of an asset to lose its value due to the issuers' violation of fiduciary responsibilities under *shariah* law (Tariq & Dar, 2007). Therefore, it is paramount to comply with *shariah* principles to ensure legitimacy as well as to evade the elements of *riba*, *maisir* and *gharar*. As the *shariah* compliance issues are very subjective and can be

interpreted in different ways, it has produced different *shariah* standards and guidelines between jurisdictions in structuring a *sukuk*. For instance, the statement made by Sheikh Taqi Usmani in November 2007 that most of non-*ijarah sukuk* issued in the market are non-*shariah* compliant⁸ causes mix perception on *sukuk* structure and Islamic finance as a whole. It is also viewed as one of the strong reasons that lead to the shrinking of global *sukuk* issuance in 2008. Indeed, in Malaysia *sukuk mudharabah* and *musharakah* are permissible. Thus, consistency of *shariah* ruling between regions is very much needed to avoid uncertainty and confusion among Islamic capital market players.

Sukuk structure is exposed to *shariah* non-compliance risk for whole of its tenure. Underlying asset of a *sukuk* must be *shariah* approved and it can be tangible or intangible asset⁹ and AAOIFI has highlighted that *sukuk* must not represent element of receivables or debts. In Malaysia, SAC has allowed receivable or debt component to be used as an asset in *sukuk* issuance.¹⁰ These receivable or debt must be derived from Islamic transaction and not from the conventional transaction. For example, *Sanadat Mudharabah* Cagamas are Islamic bonds issued under the Islamic principle of *mudharabah* (profit-sharing) to finance the purchase of Islamic home financing debts. Similar practice also has been done in Saudi Arabia through the issuance of Caravan 1 *Sukuk* in 2004.¹¹

Under *sukuk ijarah*, sale of asset is remaining to be a major issue and has been addressed by many scholars and practitioners in recent years. The true sale of asset from originator to SPV must be occurred to enable the SPV to issue certificate of ownership to investor. As such, the investors hold the ownership to the underlying assets indirectly through the SPV. In fact, SPV acts as a trustee on the underlying asset. The legal ownership issue is critical should the originator become insolvent to avoid “claw back” problem. Furthermore, it is vital that SPV owns the asset legally to comply with the *shariah* principles in issuing *sukuk* certificate. This issue had been outlined by AAOIFI and stressed out that the underlying asset of *sukuk* must be owned by the investors in order to be tradable. This principle is broadly accepted including Malaysia. However, execution of transfer of ownership (sale of asset) and *ijarah* contract at same time is prohibited under *shariah* law.¹² As such, contractual parties may use purchase undertaking as an initial commitment by the SPV (lessor) to buy the particular asset from the originator (lessee). Similarly, sale undertaking could be taken to commit to sell back the asset at maturity to the originator. Although sale and purchase undertaking is not a contract, it is critical in attending to contingencies during the course of the lease such as accelerating the outstanding rentals in the event of default by the lessee (Adam & Thomas, 2005). However, AAOIFI observed the purchase or sale undertaking as a guarantee that prevents the application of profit and risk sharing.

In certain extent, originator may not always pay the specified rental or profit at specified time that may lead to the late payment and default. Basically, penalty charged on late payment or default is not derived from the underlying asset or project. Thus, it is

⁸ 85% of non-*ijarah sukuk* are non-*shariah* compliant (Zawya, 2009).

⁹ Tangible assets such as building, land, etc. Intangible assets such as usufruct of services (e.g. marketing services and delivery services) and usufruct rights (e.g. right over the use of land, right over the concession project).

¹⁰ In Malaysia, receivables are not categorized as a money and allows *sukuk* to be 100% backed by receivables.

¹¹ Caravan 1 *Sukuk* was issued in Feb 2004, totaling SR98mil. (USD26mil.). It securitized the automobile inventory of HANCO, a car leasing company. The SPV purchased the inventory (2344 vehicles) and hence the associated cash flows (lease and rental contracts), from the originator.

¹² Sale of asset (transfer of ownership) cannot be executed along with *ijarah* contract as it may create uncertainty. Should this occur, it means the contract is signed in advance and becomes effective at a future date (after sale contract is completed).

prohibited under *shariah* principles. However, SAC has permitted the investors to be compensated (*ta'widh*) due to late and default payment. The rate of compensation on late payment of profit is 1% per annum and for failure to settle the principal payment; current market rate in Islamic interbank money market will be used to determine the *ta'widh*. Both rates cannot be compounded. Investors are also allowed to receive a rebate (*ibra'*)¹³ on early settlement. This provision must be stated clearly and inserted in primary legal document of *sukuk* to avoid uncertainty.

As mentioned before, *sukuk* can be traded in secondary market. However, it must follow to ensure the *shariah* principles' conformance. Thus, Saiful Azhar (1999) has outlined the following rules to sell *sukuk* before it maturity:-

- If the *mudharabah* capital after the subscription period is over and before the operation of the specific project still in the form money, therefore, the trading of *sukuk* would be based on the exchange of money for money and it must satisfy the rules of *sarf*.
- If such capital is still in form of debt, it must be based on the principle of Islamic debt trading or exchange debt for debt.
- If such capital is in the form of money, debt, assets and benefits, trade must be based on the market price evolved by mutual consent.

To sum up, standardization of *shariah* ruling is vital to avoid confusion and to contribute further development of *sukuk* market worldwide. It might distort the rapid development of *sukuk* in providing another option of financing to capital market participants. Guidelines by AAOIFI could be initial initiative toward standardization, but it must be followed by the enforcement of these guidelines globally. In other words, *shariah* boards in respective jurisdiction used the AAOIFI's guideline in overseeing the practice of *sukuk*.

ii. Legal and regulatory risk

Malaysian *sukuk* market is governed by various legislations, rules and guidelines by numbers of authority bodies. Security Commission of Malaysia (SC) and Labuan Offshore Financial Services Authority (LOFSA) are the specific bodies that regulated the practice of *sukuk* for onshore and offshore Islamic capital market respectively. Thus, the issuance of *sukuk* must comply with the directives from these authorities. For example, *sukuk* that issued onshore must fulfill the requirement under Policies and Guidelines on the Issue/Offer of Securities, Minimum Contents Requirements for Trust Deeds and Guidelines on the Offering of Asset-Backed Securities. Furthermore, transferable and tradable *sukuk* rating is a must in Malaysia and indicative rating must be submitted along with the application to issue *sukuk*. Although no minimum rating is required, *sukuk* must be rated by rating agencies recognized by SCM.¹⁴

Changes in regulatory by the authorities may expose the originators or issuers of *sukuk* to legal and regulatory risk. Furthermore, in jurisdictions where English and common law (e.g. Malaysia) is practiced and in the absence of *shariah* laws, the former

¹³ According to SAC, *ibra'* clause in the primary legal document is considered as *syart* (condition) which in compliance with *muqtadha`aqd* (purpose of contract). SAC has advised that the *ibra'* clause can be inserted in the payment and settlement section.

¹⁴ The rating agencies could be domestic or international agency. RAM Holding (formerly known as Rating Agency Malaysia Berhad) and Malaysia Rating Corporations Berhad (MARC) are two domestic rating agencies recognized by SC.

will be applied. According to Raja Teh Maimunah (2010a), the issuance of *sukuk* may be structured to comply with *shariah* principles but the rights of investor and issuer's responsibilities are governed by English law. Indeed, lack or almost non-existent separate Islamic law that governed this specific issue contributes to the relying on the conventional laws in settling court disputes. It then solved accordance to the applicable provisions under English law. The Contract Act 1950, Company Act 1965, Trust Company Act 1949 and Trustee Act 1949 could be used in Malaysia to determine the investors' right and issuer's responsibilities. This issue is mainly arise when originator become insolvent.

Complete legal documentation for *sukuk* issuance is imperative in order to deal with *shariah* issues. In fact, *sukuk issuance* is substantially requires more documentation and legal due diligence compared to conventional bond. For example, sale and lease back agreement under *sukuk ijarah* might violate the *shariah* principles. Signing *ijarah* contract in advanced (together with sale of asset agreement) but become effective in the future date consist the element of uncertainty. As such, purchase undertaking is required to ensure the agreement is exercisable under *shariah* law. However, contractual parties in *sukuk issuance* must be well aware whether the purchase undertaking is enforceable under English law. Thus, incomplete legal documentation might expose the *sukuk* transaction to *shariah* non-compliance risk as well as legal risk.

The listing of Malaysian *sukuk* started since 2002 when Malaysian Global *Sukuk* was listed in Luxembourg Stock Exchange, Bahrain Stock Exchange and LFX. However, the listing of *sukuk* in Bursa only begins in August 2009 by the inaugural listing of PETRONAS *Al-Ijarah Sukuk*. As mid-July 2010, there are 13 *sukuk* listed in Bursa under the exempt regime including the first foreign *sukuk*, GE Capital *Sukuk* Ltd. Although *sukuk* are listed under exempt regime, it does not mean that it could avoid the listing requirements by Bursa Malaysia. Exempt regime means that the *sukuk* will not be quoted or traded on the exchange and basically, it is traded over-the counter (OTC). In fact, the listing requirements for *sukuk* are similar to conventional listing requirements. It also must comply with the rules and regulations introduced by Bursa and the issuer of *sukuk* must obtain the approval from SC before been listed in Bursa Malaysia. The authorities might change the rules and regulation at anytime to improve the efficiency and effectiveness of *sukuk*'s secondary market. As such, the issuer must be well aware on any changes to avoid the risk of being delisted from the exchange.

Identifying the underlying risks is vital in order to facilitate the development, practice and application of *sukuk* structure. Thus, the previous discussion on underlying risks for both *ijarah* and *mudharabah* structures can be summarised in Table 2.

Table 2: Underlying Risks in *Sukuk Ijarah* & *Sukuk Mudharabah*

TYPE OF RISK	SUKUK IJARAH	SUKUK MUDHARABAH
1.	FINANCIAL RISK	
1.1 Market risk		
1.1.1 Rate of return risk	<ul style="list-style-type: none"> - Fixed rate -Market value of <i>sukuk</i> are not always relevant to interest rate/reference rate movement. -Return is fixed for the whole tenure of <i>sukuk</i>. Rising in reference rate would create "opportunity cost" for investors. - Floating rate -Rate of return is varied for entire 	<ul style="list-style-type: none"> - Rate of return and <i>sukuk</i> market values is determined by project performance.

		tenure of <i>sukuk</i> .	
1.1.2	Foreign exchange risk	- Floating rate is riskier than fixed rate. - Underlying asset composition - <i>Ijarah</i> is more vulnerable to this risk compare to <i>mudharabah</i> . - Tenure - <i>Sukuk</i> with longer maturity is highly exposed to this risk compare to shorter maturity.	
1.1.3	Price risk/ Asset risk	- <i>Ijarah</i> is vulnerable to price risk compare to <i>mudharabah</i> due the present of tangible asset in its structure.	
1.2	Credit risk	- Credit risk is non-payment of rental at specified time and the possibility of issuer to be unable to redeem the underlying asset at maturity date.	- Credit risk is non-payment of profit share by the <i>mudharib</i> at specified time as the principal invested is guaranteed at maturity by third party.
1.3	Liquidity risk	- Tradable in secondary market through OTC before maturity - Most of holders are tend to hold the <i>sukuk</i> until maturity.	- Tradable in secondary market through OTC. - At maturity, <i>sukuk</i> holder has the right to transfer the ownership by sale or trade in the securities market.
1.4	Performance risk	- Performance of underlying asset does not affect the rental payment but the overall originator performance could affect the ability to pay the rental for the whole tenure of the <i>sukuk</i> .	- Value of <i>sukuk</i> is solely depends on the project performance and investor will bear all the losses if the project is underperform.

2.

NON-FINANCIAL RISK

2.1 Operational risk

2.1.1	<i>Shariah</i> non-compliance risk	- Investors are allow to be compensated (<i>ta'widh</i>) due to late and default payment or rental. - true sale of underlying asset must be occurred.	- Underlying asset in term on receivable derived from Islamic transaction is allowable. - Investors are allow to be compensated (<i>ta'widh</i>) due to late and default payment of profit. - If traded before maturity, must follow the rules outlined by Saiful Azhar (1999).
2.1.2	Legal and regulatory risk	- Requires more documentation compare to conventional bond in dealing with <i>Shariah</i> issue. - Exchange listing requirements under Exempt Regime.	

Source: Authors' compilation (2010).

4.4 Risk Mitigation in *Sukuk*

Financial risk management is the practice of creating economic value in a firm by using financial instruments to manage exposure to risk. Risk management requires identifying sources of risks, measuring and mitigation; and it can be qualitative and quantitative.

Specific to financial risk management, it focuses on when and how to hedge using financial instruments to manage costly exposures to risk.

Risk is inherent in any transaction, whether Islamic or conventional but the former assume additional risk, i.e. *shariah* non-compliance risk, of what *shariah* considers being a compliant investment product within the ethical and financial parameters. Nowadays, as the structure of Islamic financial contracts is enhanced with more elements, institutions offering Islamic products should be able to identify the types of risks that they face by employing such contracts during structuring process.

As far as risk management in *sukuk* are concerned, the prevailing question for regulators and practitioners alike is certain features of *sukuk* structure and the underlying risks. As noted before, there are a wide range of *sukuk* structures. Some *sukuk* are more akin to debt-based instruments, others have equity-like characteristics, whilst others mirror conventional asset-backed structures. Differences in the structure have significant implication on the underlying risks.

In the Islamic finance industry, conceptual definitions can give rise to products with differing risk, legal and economic characteristics. Terms such as *musharakah*, *mudharabah*, *murabahah* and *ijarah* are generic categories which originate from the different nominate contracts used in early Islamic history. These terms define types of transaction which underpin specific products – but they are not the products themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly different in terms of their risk profiles and economic substance.

The issue of series of high profile *sukuk* defaults in the GCCs is more of credit (default) and legal risks rather than the *sukuk* structure. For instance, the absence of clarity of how the issuer of Nakheel *Sukuk* had planned to meet the payment obligations upon maturity (redemption) date; the uncertain rights of the investors and issuer's responsibilities which are governed by English law or UAE law, i.e. one must see how assets could be seized under both laws, not under *shariah* law since the *sukuk* was structured to comply with *shariah* principles.

This part will only discuss risk mitigation in *sukuk* for two types of risk, namely credit risk and legal risk which represent financial and non-financial risk, respectively.

4.4.1 Credit (default) risk

Certainty with regard to the post-default process in *sukuk* transactions is necessary because the potential for a default exists in all types of transactions. Even the most prudently structured products can fail due to circumstances outside investors' control. Clarity as to what may reasonably be expected in a default scenario with respect to any financial transaction leads to an enhanced ability to foresee and mitigate the risks inherent to that type of transaction. Until a right is interpreted and enforced, the benefits enjoyed by the person holding that right are limited to the benefits resulting from the obligations that the corresponding obligor is willing or able to perform. In a sense, defaults in a type of transaction reveal the actual rights held by investors in that type of transaction. Knowledge of such rights allows the financial practitioners structuring and documenting that type of transaction greater ability to mitigate the risks. The foregoing applies to a great extent to the *sukuk* market.

Current defaults in *sukuk*, though unfortunate in a number of respects, are not entirely negative occurrences. Nor can it be said that those defaults alone represent a maturation of the *sukuk* market, but likely to prove means for the maturation. Instead,

each default represents another incremental opportunity for increased knowledge about the relevant *sukuk* and its underlying structures. Increased knowledge will better equip those structuring and documenting *sukuk* transactions to understand and address the risks facing those *sukuk* transactions. Ultimately, the *sukuk* defaults should not be regarded as a failure of the instrument itself but a multitude of things typical of any credit issue.

4.4.2 Legal risk

The question for regulators and practitioners alike is that in the context of securities legislation configured for conventional products, how instruments such as *sukuk* fit under the existing frameworks. In addition, there can be a lack of clarity in regulatory classification of Islamic finance products. Securities legislation has historically been crafted to deal with conventional products, and Islamic securities which are structured to replicate the function of conventional products may be categorised differently, or not captured at all, under existing frameworks, due to differences in their underlying legal, economic or risk structures.

In fact, the knowledge factor is compounded in the context of *sukuk* products as the assets on which such products are based (or by which they are backed) are scattered in multiple jurisdictions which apply different legal systems (Islamic, common law, civil law or hybrid legal systems) and which may vary in terms of the maturity of their judicial systems and enforcement mechanisms. This gives rise to the need for a comparative study of how each default is being handled in the relevant jurisdictions. Such study will be far from complete absent meaningful cumulative feedback on the manner by which *sukuk* default scenarios were treated.

Regulators should put more emphasize on the economic and risk characteristics of the contractual arrangements which underpin *sukuk* with a view to provide a consistent and appropriate level of regulation. In practise, this may mean fitting *sukuk* within existing products classification or creating new regulations, different types of *sukuk* may even be regulated differently.

5. CONCLUSIONS

The Malaysian *sukuk* market presents some challenges for investment. It is relatively immature and concentrated at RM168 billion (outstanding as at March 2010). Many risks can be mitigated with appropriate asset allocation, a relevant investment process, and an appropriate subscription redemption cycle. In this study, we made an effort to identify the risks underlying *sukuk* structures and suggest some possible methods of mitigating such risks. Indeed, the subject is an emerging one and offers rich potential for further research as the Islamic capital market continues to grow. For instance, there is an urgent need to develop risk management tools including hedging against currency and yield curve movement to ensure that Islamic financial institutions can grow in a prudent and controlled manner.

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