Sukuk: Does it minimize risk?

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Abstract:

Recently, there has been a rapid growth of a booming multibillion-dollar market in Shariah-compliant sovereign and corporate Islamic structured financial instruments known as Sukuk. As shari'ah considers money to be a measuring tool for value & not an asset to itself, it requires that one should not be able to receive income from money alone. The generation of money from money (interest) is riba, & is forbidden. Sukuk are asset-backed, stable income, tradable and Shariah-compatible trust certificates. In addition, the globalization of financial markets and increased convergence of Islamic finance and conventional markets, indirect interest rate effects and other financial risks will necessitate the development of Islamic financial risk management techniques. This paper aims to analyze the risk of the Sukuk compared to other financial instruments. Also, it aims to assess the impact of Sukuk on the cost and risk structure of investment portfolios.

Keywords: Islamic finance, Sukuk, Risk, Stock market, Bond Market

1 INTRODUCTION

Debt and leveraging are the main sources of financial instability in most of the current financial systems. So, In order to enhance financial stability, regulators would have to adopt policies and practices that hurdle excessive debt creation, and leveraging, as well as to achieve justice and fairness in the distribution of resources. A system that seeks all these policies and eliminates excessive risk by prohibiting debt and risk-shifting in favour of risk sharing and equity finance is "Islamic Finance".

Islamic finance refers to a system that functions on the principles of Islamic Law, called Sharia.

The Islamic banking and finance sector is increasing its valuable market in the global finance industry. Today, over 300 Islamic banks and financial organizations are successfully running their business from many cities in the world. Islamic finance is growing at 10 to 15% per year, and there is no sign that this trend is going to slow down in the near future and as such it is one of the fastest growing segments of global finance in the world. In recent times the Islamic bond (Sukuk) market has registered a phenomenal growth all over the globe including non-Muslim countries.

Sukuk markets become a market where investors are interested in, which raise questions and consequently observations about this newly developed market, and the level of risk accompanied with it. This paper aims at finding an answer to a critical question in investment, which is "Does Sukuk minimize Risk?", the paper will highlight the main differences between Sukuk , Stocks and Bonds, the advantages and constraints accompanied with

Sukuk, adding to this a highlight will be given to the Malaysian successful experience, along with discussing the role of Sukuk in the global financial crisis that took place in 2008-2009. In the last section of this research the authors will give recommendations regarding how to improve Sukuk market efficiency and reduce their risks.

2 WHAT ARE SUKUK?

Sukuk are a plural Arabic name of sakk. Sukuk are riba-free Islamic finance certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, and services, or equity of a given project or equity of a special investment activity (Khalil, 2011)(AAOIFI,2008). The Sukuk holders claim an undivided beneficial ownership in the underlying assets. The Sukuk invest money as per Shariah principles in Halal businesses and can be structured based on innovative applications of Islamic principles and concepts (Ahmed,2011).

Islamic Financing must be raised only for identifiable assets. Shari'ah requires that financing should be raised only for trading in, or construction of, specific and identifiable assets. Trading in "indebtedness" is prohibited, and so the issuance of conventional bonds would not be compliant. Thus all Sukuk returns and cash flows will be linked to assets purchased or those generated from an asset once constructed and not simply be income that is interest-based.

2.1 Difference between Sukuk, Bonds, & Stocks:

Comparison	**SUKUK**	**BONDS**	**STOCKS**
Type of Security	Share of revenue stream	Debt	Ownership in a corporation
Type of Return	Profit sharing	Coupon	Dividends
Maturity Date	Specified	Specified	Unspecified
Issue Price	Face value based on the market value of the underlying asset.	Face value based on the issuer's credit worthiness	Face value based on the market value of the company
Priority in Paying Principle	First priority	First in priority	Less in priority
Risk	Lower	Lower	Higher
Voting Rights	Not authorized	Not authorized	Authorized
Effects of changes in costs related to assets	Affected	No effect	Affected

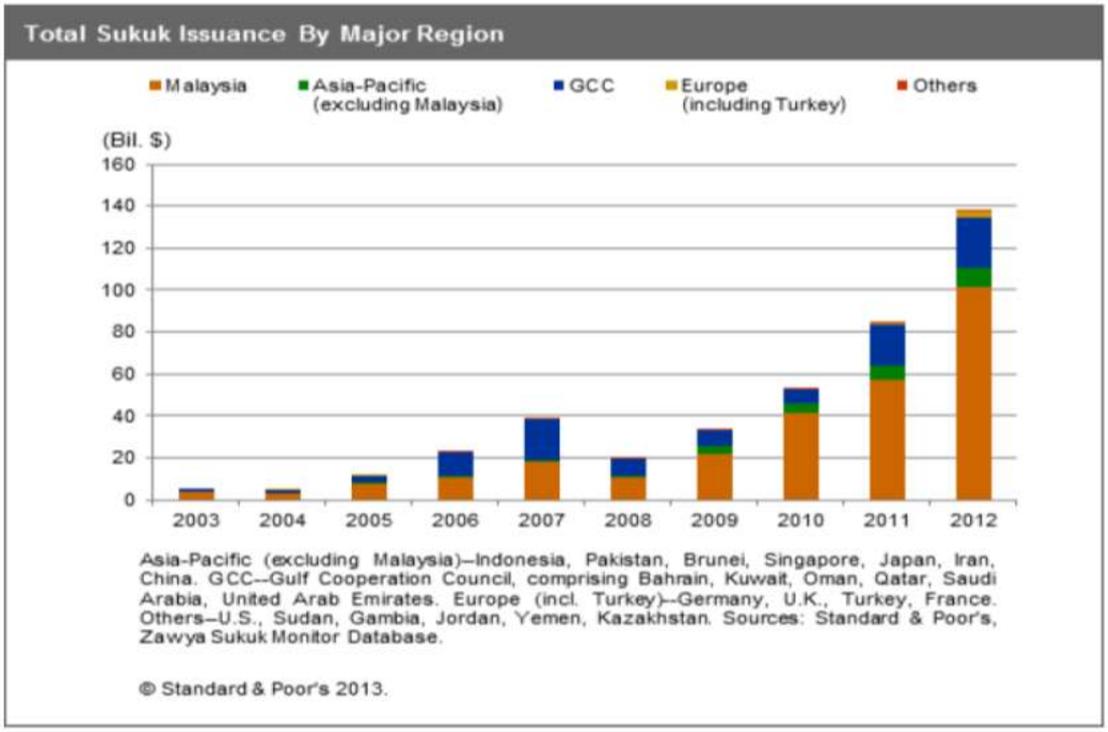
3 THE MALAYSIAN EXPERIENCE:

The Islamic financial system in Malaysia has witnessed a remarkable growth since it was first introduced in 1963. It started from a modest beginning with the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji) (that guarantee the savings of Muslims are free from elements of usury and that its activities are carried out according to the Shari'ah requirement). Later, in 1983; The Malaysian government was the first issuer of Sukuk to enable asset management in the promising Islamic banking sector. Then, Malaysia offered its first private Sukuk issued in 1990 which was RM 125 million by shell Mds[1] followed by Malaysia's full-fledged Islamic stock broking company, BIMB Securities SdnBhd[2] in 1994.Then, in 2007 The first international Sukuk was issued by May bank. Since2007, the market has mushroomed in Malaysia & globally (Shaikh & Saeed, Sukuk Bond: The Global Islamic Financial

[1] Shell MDS (Malaysia) Sdn. Bhd. (SMDS) is a joint venture of Mitsubishi Corporation, the Royal/Dutch Shell Group of Companies (Shell), state-owned Petroliam Nasional Berhad (Petronas) and the Sarawak State Government. SMDS is the world's first commercial project to employ Gas to Liquids (GTL) technology, which can be used to produce petroleum products, chemical products, wax, and other materials from natural gas.

[2] BIMB Securities Sdn Bhd (BIMB Securities), the first full-fledged Shariah compliant stockbroking in Malaysia to serve Muslim and non-Muslims was established in 1994. It is the only Shariah compliant participating organization of Bursa Malaysia Securities Berhad (Bursa), principally to carry out dealing in securities on Bursa and other permitted business activities.

Instrument, 2010). According to Bloomberg; Sukuk reached its highest peak in 2007 before the global downward in 2008.



Malaysia nowadays is the leader of Sukuk-industry worldwide (See table 1 in Appendix A). It has a deep and broad market with wide-ranging regulations that facilitate Sukuk issuances, well-executed policies, facilitative regulatory environment, a favorable tax regime, a sophisticated investor base as well as support from all issuers, regulators and investors. Today, Malaysia is currently known as the most favoured destination for issuers in the Sukuk market dominating 60% of the global share worth US$100 billion (in 2012).

4 ADVANTAGES AND DISADVANTAGES OF SUKUK:

The below table summarizes the advantages versus the disadvantages of Sukuk:

Advantages	Disadvantages
1. Sukuk are riba-free products based on Islamic principles. 2. Sukuk are among the best ways of financing large enterprises that are beyond the ability of a single party to finance. 3. Security instrument that provides a predictable level of return (fixed or floating). 4. Traded in the secondary market	1. Sukuk inherently entail a higher exposure to certain risks. The most important are the market risk, operations risk and Shari'ah compliance risk. 2. Sukuk offer lower return compared to conventional bonds. 3. Sukuk are illiquid instruments compared to conventional bonds as evidenced by the lack of secondary market activities.

5. Assessed and rated by international rating agencies. 6. Including Sukuk in a portfolio of investments could reduce the portfolio's VaR[3] compared to that of a portfolio consisting only of conventional bonds (due to the small correlation between Sukuk returns and conventional bonds returns). 7. Sukuk have lower cost of funding, the flexible tenor and reducing lead times of transaction as compared to conventional bonds. 8. Sukuk are a means for the equitable distribution of wealth as they allow all investors to benefit from the true profits resulting from the enterprise in equal shares (S.Shahida & Sapiyi, 2013). 9. A risk sharing instruments not a risk-transfer one.	4. The initial investment isn't guaranteed; the Sukuk holder may or may not get back the entire principal (face value) amount. That's because, unlike conventional bond holders, Sukuk holders share the risk of the underlying asset. If the project or business on which Sukuk are issued doesn't perform as well as expected, the Sukuk investor must bear a share of the loss.

(Cakir & Raei, 2007)

As it is clear from the disadvantages of Sukuk, they inherently entail the exposure of market and financial risks. Market risk is defined as the risk on instruments traded in well-defined markets (Heffernan, 2003) (Tariq, 2004). Market risk can be either systematic risk which can be caused by governmental or political changes or unsystematic risk, which is firm related risk. Market risk is composed of interest rate risks, foreign exchange risks, equity price risks and commodity risks.

Interest rate risk:

Fixed-rate Sukuk face interest rate risk. For example, suppose that an investor is entitled to the fixed interest rate of a saak for 2 years, and the interest rate in the market increased, this investor will lose the opportunity of taking the higher interest rate. While Volatile-rate Sukuk face another form of interest rate risk, as they are benchmarked with LIBOR, when the LIBOR rates increase, the issuer had to pay the new increased rate as indicated by the LIBOR in order to share market profits with the Sukuk holder.

Foreign exchange rate risk[4]:

Currency risk arises from unfavourable exchange rate fluctuations which will undeniably have an effect on foreign exchange positions .Whenever there is a mismatch 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 vulnerable to an exchange risk. Some countries have managed to mitigate this type of risk, for instance, the Chinese government that diversifies the pool in different currencies. (Tariq, 2004)

Credit risk:

[3] VaR: measures the downside risk of a portfolio position as the maximum loss that can materialize at a future prescribed date with a given probability due to adverse changes in relevant asset and liability prices.

[4] It is noticeable that the Chinese government has implemented a simple method of eliminating such a risk. They divide the issue in to two parts. Suppose the issue is $1 billion. The first part of $ 400 million will be in US Dollars and the second part of $ 600 million will be in Euro. Indeed, the Sukuk issues can be based on this simple principle and can be based on multi currencies instead of creating a contingency claim on the issuer's balance sheet in terms of the guarantees.

Credit risk refers to the probability of default on payments/repayments by the originator. The rescheduling of debt at a higher mark-up rate does not exist due to the prohibition of interest. Consequently, counterparties would be more inclined to default on their commitments to other parties (Tariq, 2004).

SHARI'AH Compliance Risk:

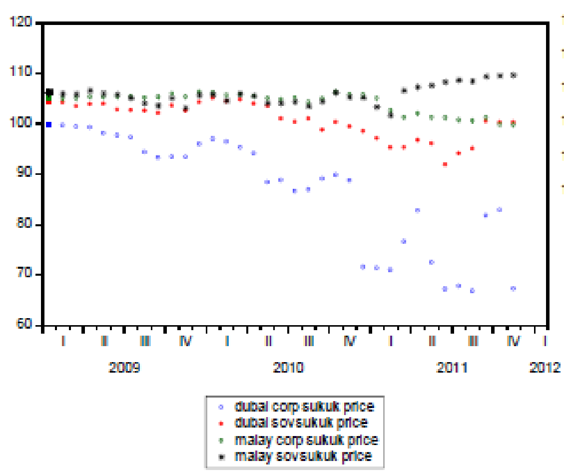
Is a unique risk to Sukuk. There is a risk that Ijtihad and issuance of new fatwa results in Sukuk no longer being shari'a compliant.

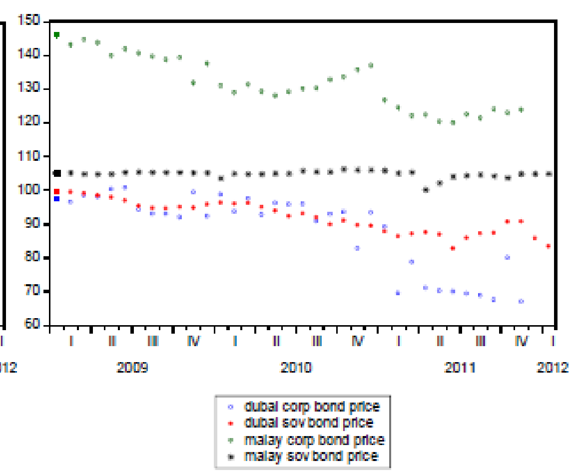
Widespread mismanagement in recent issuance of Sukuk can be a reason behind high risks associated with Islamic securities. In addition to the above mentioned risks, there are also some constraints to the issuance of Sukuk, such as Taxation. This is an issue for certain investors where the legal basis for taxation of Islamic securities is not legislated in the home country. Moreover, investor protection mechanism remains largely untested. Challenge for Sukuk issuing entities to devise an effective risk management strategy congruent to Shari'ah principles is considered a third constraint to issuing Sukuk. Sukuk issuing entities should take some steps forward regarding facilitating Sukuk's infrastructure and their regulatory framework which may affect the interest of corporate business to enter into Sukuk market, as well as providing an efficient pricing model, which is compliant with Islamic law principles, because there is a lack of researches discussing this point (finding fair value of Sukuk).

5 ADDING SUKUK TO A PORTFOLIO OF BONDS:

Although international issues of Sukuk are similar to conventional bonds in some features like rating, issuance, redemption procedures, and default clauses (Shaikh & Saeed, Sukuk Bond: The Global Islamic Financial Instrument, 2010). It was found that Sukuk have higher correlation between each other comparing to the correlation between conventional bonds. This means that a portfolio of pure Sukuk will have a higher risk comparing to a portfolio of pure bonds. The reasons of the higher risk are that Sukuk have higher market & credit risk due to restrictions of Sharia'ah principles force on Sukuk risk management. In addition to the previous risk; Sukuk should be backed by real investments, which limit diversification among Sukuk. Also, Sukuk suffer from the absence of risk management derivatives; that leads to revealing investors to all types of risk without having risk management tools that exist in the conventional finance market. These restrictions exist only in Sukuk & don't exist in conventional bonds (Hassan, 2012).

On the other hand, correlation of Sukuk returns with returns on conventional bonds is much smaller than the correlations of returns on conventional bonds with each other. This low correlation will lead to a decrease in VaR of portfolio that consists of both Sukuk & bonds. This reduction in VaR is a result of diversification that comes from adding another instrument to a portfolio with different or similar durations and the different behavior of Sukuk prices in the secondary market compared to conventional bonds[5].





[5] Two limitations were highlighted from this study, first the data sources were only restricted to two countries; which are UAE-Dubai and Malaysia, the second limitation is that the time frame was a 3-year holding period when applying the VaR model

(Hassan, 2012)

In addition, it was found that stock market was responding neutral to the announcement of conventional bonds and significantly negative to the announcement of Sukuk. This difference in responding was explained by the ability of the market to distinguish between these securities

	Mixed Portfolio	Pure Bond Portfolio	Pure Sukuk Portfolio
Delta-Normal VaR	37.8	56.9	76.8

(Hassan, 2012)

6 THE GLOBAL FINANCIAL CRISIS AND THE ROLE OF SUKUK:

Global financial crisis that took place in 2008-2009 had affected the world economy whether in the west or the Middle East, as well as the stability of the conventional financial system, where excessive leveraging, combined with an inherent asset-liability mismatch, which threatens the overall soundness of the financial system (Askari, 2012).

Global financial crisis was mainly due to the following factors, first the inadequate market discipline in the financial system resulting from the absence of profit –loss sharing, second the great expansion of the derivatives market, and finally due to the inefficiency of some banks and the rescue of the central bank to them (Ahmed, 2010).

Islamic finance market is part of the financial system that has been affected by the financial crisis; different arguments were reached whether Islamic finance was realistically affected from the global financial crisis, or because the fact that is based on profit-loss sharing basis, it is not affected that much.

Some researchers viewed that Islamic finance in general is based on an Islamic financial system, which is superior to the conventional financial system, as it does not get involved in any social harmful activities, its emphasis is on investment (Salah) , productivity , increasing the financial flow in the economy and that Islamic finance can minimize the severity and frequency of financial crisis (Ahmed, 2010), adding to this that Islamic financial system tends to move against any potential risk resulting from excess leverage and speculative financial activities (Ahmed, 2010), Islamic financial system requires a great level of disclosure and transparency, which is missing in the conventional financial system (Ahmed, 2010). Moreover, Islamic financial system does not depend on debt, but it depends on equity finance, which could help Islamic finance not be affected negatively by the financial crisis (Askari, 2012).

Islamic finance industry is considered to be less risky, because financial transactions are backed by physical assets, not by underlying financial assets, as the case in the derivatives market (Alasrag, 2010).

On the contrary Islamic finance industry tend to be more vulnerable specially to fluctuations in the mortgage market, given their high activity in the real estate sector (Alasrag, 2010) which could be reached that still Islamic finance in one way or another is part of the global financial crisis.

An in depth focus on the Sukuk market which is the main focus of this paper showed that due to the global financial crisis there has been slowing down in Sukuk issuance, and that the international Sukuk market faced high level of illiquidity because of the decline in the oil prices and the lack of confidence of the investors after the crisis in any sort of financial investments (Alasrag, 2010), also there have been set of numbers of defaults affecting Sukuk issuances (Salah).

As there are different challenges facing Islamic finance in general, and Sukuk market in specific it is also expected that on the long run the viability of this market will be strong, and more investments and financing will be needed in the Middle East area, and that Sukuk could be used as a hedging tool, and that it is more reliable to aggressively enter the Middle East market instead of depending on the derivatives market, which is based on underlying assets and not on speculation, which is prohibited in the Islamic financial system.

With the aggressive entrance of Sukuk in the financial World, the investors will have better options to invest in, that will hold considerable value and benefit for all, In addition Sukuk promise an equitable and justifiable level of return which is safe for strategic investment purposes (Shaikh & Shad, 2010).

7 CONCLUSIONS:

The authors can conclude that a portfolio consisting of pure Sukuk is more risky than a portfolio of pure bonds. On the other hand, adding Sukuk to a portfolio of pure bonds will decrease the risk of the portfolio (VaR) comparing to portfolio of pure bonds because of diversification.

It is also worth noting that the majority of Islamic finance customers are non-Muslims, with an increasing presence of foreign investors (PricewaterhouseCoopers, Malaysia, 2008) (Krasicka & Nowak, 2012) as it is based on ethical behaviors which encourage global investors to be interested in it. Consequently there is a need for efficient Sukuk market, and in order to realize this more rational and efficient Sukuk market, the awareness of the benefits of Sukuk has to be shown as compared to conventional bonds i.e. the lower cost of funding, the flexible tenor and reducing lead times of transaction (S.Shahida & Sapiyi, 2013). Besides, Policies that could improve transparency and information disclosure are needed. The policies also must be able to create better incentives to attract investors to increase their trading activities in the secondary market thereby increasing the liquidity of Sukuk market, which in turn drive the market to become more efficient (Rusgianto & Ahmad, 2013).

Finally, to be able to issue a well-based statement and say that Sukuk do minimize risk, there is still a need to have more researches on how to price Sukuk, a need to more measures that can help improve Sukuk market efficiency and reduce their risks such as; Standardization of the Sukuk issuance. Active collaboration among different Islamic regulatory organizations and governmental institutions as well as further development of Sukuk secondary market is also needed. Moreover, it is important to diversify Sukuk issues in terms of their maturities, geographical locations and sectors of industry, and to create appropriate legislative basis to handle the disputes including possible default.

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Appendix A:

(IIFM Sukuk Issuance Database, 2011)

Table 1: Regional Breakdown of the Total International Sukuk Issuance, 2001 - 2010

ASIA & FAR EAST	Amount (USD million)	Number of Issues	% of Total Value
Malaysia	5,496	12	12%
Indonesia	650	1	1.4%
Pakistan	600	1	1.3%
Brunei Darussalam	200	2	0.42%
Total	6,946	16	15%
GCC & MIDDLE EAST	Amount (USD million)	Number of Issues	% of Total Value
Bahrain	5,633	90	12%
Qatar	2,020	4	4%
Saudi Arabia	5,440	9	11%
UAE	25,050	30	52%
Kuwait	1,575	9	3%
Total	39,718	142	83%
AFRICA	Amount (USD million)	Number of Issues	% of Total Value
Sudan	130	1	0.3%
Total	130	1	0.3%
OTHERS	Amount (USD million)	Number of Issues	% of Total Value
Japan	100	1	0.2%
Turkey	100	1	0.2%
UK	271	2	0.6%
USA	600	2	1.3%
Total	1,071	6	2%
Grand Total	47,865	165	100%