CHAPTER NINE

RISK FACTORS IN ŞUKŪK STRUCTURES

As it is the case with any financial instrument, şukūk structures involve a number of risks that are associated with their issuance. Needless to say these risks include the country risk and the risk related to the sector the originator or the underlying assets belongs to. However, what concerns us most here are the risks related to the şukūk directly such as the credit risk and counterparty risk, operational risk, and the market risk, which includes foreign exchange risk and rate of return risk. In addition, there are also the legal risk, taxation risk and the liquidity risk.

Rate of Return Risk

In general terms, the rate of return risk in şukūk is the equivalent to that of interest rate risk in conventional bonds. Based on the şukūk outstanding in the market, it could be noted that şukūk based on fixed rates are exposed to this risk in the same manner as fixed rate bonds are exposed to the interest rate risk. şukūk certificates are also exposed indirectly to interest rate fluctuations through the widespread benchmarking with LIBOR in their financing operations. Consequently, the nature of these instruments is that they are exposed to fluctuations in the LIBOR rate or even other market rates. Every contract benchmarked with LIBOR inherits the possibility that in the future the LIBOR rates will rise and that the issuer, on the asset side, will not have made as much profit as future market conditions might dictate. The şukūk issuers will have to respond to fluctuations in LIBOR because any increase in earnings will have to be mutual with the investors. However, in cases where the şukūk portfolio is a hybrid composed of ijarah plus murābahah or istiṣna’ for instance, the re-pricing of murābahah contracts is not possible as debts are non-tradable except at par. Therefore, we have a situation where murābahah contracts expose the issuer as well as the buyer of the issue to a considerable profit rate risk, albeit indirectly. Some of the şukūk issuances, such as the IDB trust certificates, have an underlying portfolio of assets that include
murābahah receivables, rendering the whole issuance indirectly exposed to interest rate risk.¹

The rise in market (interest) rates leads to the fall in the fixed-income šukūk values. Suppose on January 1, 2004, an investor buys a 2 year šukūk at 10% annual return rate. On January, 2, the market rates increase to, say, 15%. Although the market rates have changed, the šukūk holder will still get the 10% coupon payments. Hence, his asset now earns less than the 15% market rates. All fixed return assets either from ijārah, istiṣnā’, salam or any other origin will face this risk. This also entails reinvestment risk and an opportunity cost of investing at the new rates, particularly if the asset is not liquid as is the case of the zero-coupon non-tradable šukūk. Maturity plays a very important role in intensifying the impact of this risk. Suppose the šukūk were for a 10 year maturity instead of 2 years. The investor will face the reinvestment risk for 10 years. Adverse changes in market rates will also unfavourably affect the credit worthiness of the issues and will lead to the increase in the credit risk of the issue.

Risk Factors Relating to the Purchase of the Assets
This issue is apparent in the case of unregistered land which is generally owned and registered in the name of the ruler as it is in the case of Dubai. Transfer of property takes place pursuant to the directives and policies of the Land Department. Title may pass either as freehold or by way of long term lease. However, if the buyer entity is registered in the Gulf Cooperation Council (GCC) the legal transfer may not be an issue. However, in some instances, a clause of liquidated damages would be included in the deed sale whereby the seller undertakes to pay the issuer the value of the šukūk.

Asset Risk
The underlying assets of the šukūk certificates are subject to numerous risks as well. Primarily, there is the risk of loss of the assets. These are minimal with regard to ijārah assets of land parcels. However, in the case of equipment and large scale construction equipment, cars or machines, for instance, the risk of loss may not be so negligible.