

**RELATIONSHIP BETWEEN RISK AND RETURN IN
SUKUK MARKET**

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By

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**Thesis Submitted to
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ABSTRACT

This study attempts to identify the different types of risk embedded in the sukuk structure and to determine the relationship between the risks and the returns of sukuk. Data were collected from seven groups of the sukuk market from 2005 to 2013 on a periodic monthly basis and analyzed using correlation analysis and multi-regressions analysis. The test results confirm the significant influence of market risk, credit risk, operational risk and liquidity risk on the sukuk returns in different ways. The results of the analysis on the basis of maturity indicate that the longer the period of maturity the higher is the risk exposure. The results of the analysis on the rating indicate that the impact of risk is very high on lower- rated sukuk. The sectorial- based analysis indicate that the corporate sukuk return is highly exposed to risk compared to other sectors. Analysis on the Gulf countries' sukuk market indicates that the corporate sector is more exposed to risk than the financial sector. The analysis of risk impact on the basis of selected country indicates that Bahrain's sukuk market is highly exposed to risk when compared to the sukuk markets of the UAE and Malaysia. Although, there are some limitations, the findings pave ways for a number of recommendations, among others are; maintaining inflation- rate risk at an optimal level, hedging their interest- rate risk with Libor, replacing the conventional interest rate with the Libor rate, using a common currency in the Gulf region, forming a risk- steering committee to monitor and mitigate risk, formulating a common shari'ah board at the international level, and taking necessary measures to provide a conducive environment to promote secondary markets for sukuk.

Key word: market, performance, return, risk, sukuk.

ABSTRAK

Kajian ini cuba mengenal pasti pelbagai jenis risiko dalam struktur sukuk dan menentukan hubungan antara risiko dan pulangan sukuk. Data bulanan telah dikumpulkan daripada tujuh pangkalan data dari tahun 2005 sehingga 2013 secara berkala menggunakan analisis korelasi dan regresi berganda. Hasil ujian mengesahkan risiko pasaran, risiko kredit, risiko operasi dan risiko kecairan mempunyai kesan yang signifikan ke atas pulangan sukuk. Analisis menggambarkan bahawa risiko memberi kesan yang berbeza kepada pulangan sukuk global. Hasil analisis berdasarkan kematangan menunjukkan bahawa pasaran sukuk bertempoh matang yang lebih panjang lebih terdedah kepada risiko. Hasil analisis berdasarkan penarafan juga menunjukkan bahawa kesan risiko adalah lebih tinggi ke atas pulangan sukuk berkadar rendah (lower-rated). Hasil analisis berasaskan sektor menunjukkan pulangan sukuk korporat lebih terdedah kepada risiko berbanding sektor-sektor lain. Analisis sukuk di negara-negara Teluk menunjukkan bahawa sektor korporat lebih terdedah kepada risiko berbanding sektor kewangan. Analisis kesan risiko bagi negara-negara terpilih menunjukkan bahawa pasaran sukuk di Bahrain lebih terdedah kepada risiko berbanding pasaran sukuk di UAE dan di Malaysia. Walaupun terdapat kekangangan, wujud beberapa implikasi dapatan kajian, antaranya pengendalian risiko kadar inflasi pada tahap optimum, perlindungan nilai risiko kadar faedah dengan Libor, penggantian kadar faedah konvensional dengan kadar Libor, penggunaan mata wang yang sama di negara-negara Teluk, pembentukan jawatankuasa pemandu berkenaan risiko untuk memantau dan mengurangkan risiko, pembentukan satu lembaga syariah umum di peringkat antarabangsa, dan penyediaan persekitaran yang kondusif bagi menggalakkan pasaran sekunder untuk sukuk.

Kata kunci: pasaran, prestasi, pulangan, risiko, sukuk.

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TABLE OF CONTENTS

	Page
TITLE PAGE	i
CERTIFICATION OF THESIS WORK	ii
PERMISSION TO USE	iii
ABSTRACT	iv
ABSTRAK	v
ACKNOWLEDGMENT	vi
TABLE OF CONTENTS	vii
LIST OF TABLES	xi
LIST OF FIGURES	xiii
LIST OF ABBREVIATION	xiv
CHAPTER 1: INTRODUCTION	1 - 27
1.1 Introduction	1
1.2 Background of Research	1
1.3 Statement of the Problem	6
1.4 Research Questions	18
1.5 Objective of the Study	19
1.6 Significance of the Present Study	20
1.7 Scope of the Research Study	23
1.8 Chapter Summary	26
CHAPTER 2: EVOLUTION OF SUKUK MARKET	28 – 78
2.1 Introduction	28
2.2 Introduction to Islamic Finance	28
2.3 The Concept of Sukuk Market	30
2.4 Sukuk vs Conventional Bond Comparison	31
2.5 Role of AAOIFI on Sukuk	34
2.6 Types of Sukuk	39
2.7 Evolution of Sukuk Market	51
2.8 Chapter Summary	77

CHAPTER 3: REVIEW OF LITERATURE	79 - 130
3.1 Introduction	79
3.2 Theories of Risks in Bond Market	79
3.3 Risks in the Sukuk Market	86
3.4 Relationships between Risk and Return of Bond and Sukuk	106
3.5 Methods of Measuring Risk used by Previous Studies	123
3.6 Chapter Summary	130
CHAPTER 4: METHODOLOGY	131 - 155
4.1 Introduction	131
4.2 Conceptual Framework of Research Study	131
4.3 Hypotheses Development	133
4.3.1 Interest Rate Risk vs Sukuk Return	133
4.3.2 Inflation Rate Risk vs Sukuk Return	134
4.3.3 Dollar Rate Risk vs Sukuk Return	135
4.3.4 Consumer Confidence Risk vs Sukuk Return	135
4.3.5 Legal and Shari'ah Compliance Risk vs Sukuk Return	136
4.3.6 Credit Risk vs Sukuk Return	137
4.3.7 Maturity Rate Risk vs Sukuk Return	137
4.3.8 Liquidity and Reinvestment risk vs Sukuk Return	138
4.4 Development of Statistical Model	139
4.5 Sample Design	141
4.6 Data Collection	141
4.7 Working Definitions of the Variables	144
4.8 Analysis Technique	154
4.9 Chapter Summary	155
CHAPTER 5: DATA PRESENTATION, ANALYSES AND DISCUSSION OF FINDINGS	156 – 221
5.1 Introduction	156
5.2 Descriptive Statistics of the Variables	157
5.2.1 Descriptive statistics of the dependent variables	157
5.2.2 Descriptive statistics of the independent variables	159
5.3 Graphical Presentation of the Relationship between Risk Factor and Sukuk Return	160
5.4 Correlation Analyses	162
5.5 Regression Analyses	167
5.5.1 Regression Analysis of the Overall Sukuk Market	168

5.5.2	Regression between Total Returns of DJM3T Sukuk and Its Related Independents	171
5.5.3	Regression between Total Returns of DJM5T Sukuk and Its Related Independents	173
5.5.4	Regression between Total Returns of DJM7T Sukuk and Its Related Independents	175
5.5.5	Regression between Total Returns of DJM10T Sukuk and Its Related Independents	177
5.5.6	Summary Table for Regression Models of DJ Sukuk Return Covers Maturity Basis	179
5.5.7	Regression between Total Returns of DJR3A Sukuk and Its Related Independents	180
5.5.8	Regression between Total Returns of DJR2A Sukuk and Its Related Independents	182
5.5.9	Regression between Total Returns of DJR1A Sukuk and Its Related Independents	184
5.5.10	Regression between Total Returns of DJR3B Sukuk and Its Related Independents	186
5.5.11	Summary Table for Regression Models of DJ Sukuk Return Covers Rating Basis	188
5.5.12	Regression between Total Returns of SKBI (Global) and Its Related Independents	189
5.5.13	Regression between Total Returns of SUSI (Sovereign) and Its Related Independents	191
5.5.14	Regression between Total Returns of SUCI (Corporate) and Its Related Independents	193
5.5.15	Regression between Total Returns of SUFI (Financial) and Its Related Independents	195
5.5.16	Summary Table for Regression Model of NASDAQ Sukuk Index Incorporates Global Sectorial Basis	197
5.5.17	Regression between Total Returns of HASI (HSBC Amanah) Sukuk and Its Related Independents	198
5.5.18	Regression between Total Returns of SKIX (Dubai Listed) Sukuk and Its Related Independents	200
5.5.19	Summary Table for Regression Model of Nasdaq Sukuk Index Incorporates Specific Market Basis	202
5.5.20	Regression between Total Returns of GSKI–GCC Sukuk and Its Related Independents	203
5.5.21	Regression between Total Returns of GSKC–GCC Corporate and Its Related Independent	205
5.5.22	Regression between Total Returns of GSKF–GCC Financial and Its Related Independents	207
5.5.23	Summary Table for Regression Model of Nasdaq Sukuk Index Incorporates GCC Sectorial Basis	209

5.5.24 Regression between Total Returns of AESI–UAE and Its Related Independents	210
5.5.25 Regression between total returns of BHSI–BH, and its related independents	212
5.5.26 Regression between Total Returns of MYSI –MY and Its Related Independents	214
5.5.27 Summary Table for Regression Model of Nasdaq Sukuk Index Incorporates Selected Countries Basis	216
5.6 Achievements of Objectives	217
5.7 Chapter Summary	220
CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS	222 – 244
6.1 Introduction	222
6.2 Discussion of Findings	222
6.3 Recommendations	238
6.4 Limitations and Future Research Avenues	241
6.5 Implications of this Study	242
References	245 – 265
Appendix – A	266 – 283
Appendix – B	284 – 312
Appendix – C	313 - 320

LIST OF TABLES

Table	Table Name	Page
Table 2.1	The Main Phases of Sukuk Market	52
Table 2.2	Global Aggregate Sukuk Issued Breakdown by Listing Stock Exchange	73
Table 3.1	A Summary for Risk Factors of Previous Studies in the Sukuk Market	104
Table 3.2	Methodologies Adopted by Earlier Researchers	130
Table 4.1	Listed Sukuk in Various Stock Exchanges	141
Table 4.2	HSBC/ Nasdaq Dubai Sukuk Indices	142
Table 4.3	Dow Jones Sukuk Indices	143
Table 4.4	Descriptions and Sources of Data	151
Table 5.1	Descriptive Analysis for Dow Jones Sukuk Return as Dependent Variables	157
Table 5.2	Descriptive Analysis for Nasdaq Dubai Sukuk Return as Dependent Variable	158
Table 5.3	Descriptive Analysis for the Independent Variables	160
Table 5.4	Correlation between Dow Jones Sukuk Returns and Risk Variables	164
Table 5.5	Correlation between Nasdaq Dubai Sukuk Returns and Risk Variables	166
Table 5.6	OLS Regression Results for DJ Price Sukuk Returns and Its Independents	169
Table 5.7	OLS Regression Results for DJ M3T Sukuk Returns and Its Related Independents	172
Table 5.8	OLS Regression Results for DJ M5T Sukuk Returns and Its Related Independents	174
Table 5.9	OLS Regression Results for DJ M7T Sukuk Returns and Its Related Independents	176
Table 5.10	OLS Regression Results for DJ M10T Sukuk Returns and Its Related Independents	178
Table 5.11	Regression Models of DJ Sukuk Return Covers Maturity Basis	179
Table 5.12	OLS Regression Results for DJ R3A Sukuk Returns and Its Related Independents	181
Table 5.13	OLS Regression Results for DJ R2A Sukuk Returns and Its Related Independents	183
Table 5.14	OLS Regression Results for DJ R1A Sukuk Returns and Its Related Independents	185
Table 5.15	OLS Regression Results for DJ R3B Sukuk Returns and Its Related Independents	187
Table 5.16	Regression Models of DJ Sukuk Return Covers Rating Basis	188
Table 5.17	OLS Regression Results for SKBI (Global) Sukuk Returns and Its Related Independents	190

Table 5.18	OLS Regression Results for SUSI (Sovereign Sukuk Returns and Its Related Independents)	192
Table 5.19	OLS Regression Results for SUCI (Corporate)Sukuk Returns and Its Related Independents	194
Table 5.20	OLS Regression Results for SUFI (Financial) Sukuk Returns and Its Related Independents	196
Table 5.21	Regression Model of NASDAQ Sukuk Index Incorporates Global Sectorial Basis	197
Table 5.22	OLS Regression Results for HASI (HSBC Amanah) Sukuk Returns and Its Related Independents	199
Table 5.23	OLS Regression Results for SKIX (Dubai Listed) Sukuk Returns and Its Related Independents	201
Table 5.24	Regression Models of NASDAQ Sukuk Index Incorporates Specific Market Basis	202
Table 5.25	OLS Regression Results for GSKI–GCC Sukuk Returns and Its Related Independents	204
Table 5.26	OLS Regression Results for GSKC–GCC Corporate Sukuk Returns and Its Related Independents	206
Table 5.27	OLS Regression Results for GSKF–GCC Financial Sukuk Returns and Its Related Independents	208
Table 5.28	Regression Modelsof NasdaqSukuk Index Incorporates GCC Sectorial Basis	209
Table 5.29	OLS Regression Results for AESI–UAE Sukuk Returns and Its Related Independents	211
Table 5.30	OLS Regression Results for BHSI–BH Sukuk Returns and Its Related Independents	213
Table 5.31	OLS Regression Results for MYSI –MY Sukuk Returns and Its Related Independents	215
Table 5.32	Regression Models of Nasdaq Sukuk Index Incorporates Selected Countries Basis	216

LIST OF FIGURES

Figure	Figure Name	Page
Figure 2.1	AAOIFI structure	35
Figure 2.2	International Sukuk by AAOIFI Compliance	38
Figure 2.3	Transaction Structure of Sukuk Al-Ijara	40
Figure 2.4	Transaction Structure of Sukuk Al-Musharaka	41
Figure 2.5	Transaction Structure of Mudaraba Sukuk	43
Figure 2.6	Transaction Structure of Sukuk Al-Salam	45
Figure 2.7	Transaction Structure of Murabahah Sukuk	47
Figure 2.8	Transaction Structure of Istisna Sukuk	49
Figure 2.9	Transaction Structure of Hybrid Sukuk	50
Figure 2.10	Global Aggregate Sukuk Historical Trend	53
Figure 2.11	Global sukuk historical trend breakdown by market issuance	55
Figure 2.12	Global Sukuk Trend Breakdown by Region	56
Figure 2.13	Global Aggregate Sukuk Issued Break Down by Region	57
Figure 2.14	Mena Aggregate Sukuk Issued Breakdown by Country	57
Figure 2.15	Top Five Currencies Issuing Global Sukuk	59
Figure 2.16	Global aggregate sukuk issued breakdown by currency	60
Figure 2.17	Global Aggregate Sukuk Issued Breakdown by Type Of Issuer	63
Figure 2.18	Corporate Aggregate Sukuk Issued Breakdown by Industry	67
Figure 2.19	Global Aggregate Sukuk Issued Breakdown by Sukuk Structure	69
Figure 2.20	International Sukuk Maturity Profile	76
Figure 3.1	International Sukuk Breakdown by Risk Classification	103
Figure 4.1	The Conceptual Framework	132
Figure 5.1	Fluctuation between Dow Jones Price Sukuk Return and its Related Risks	161
Figure 5.2	Fluctuation between Nasdaq Dubai Global Sukuk Return (SKBI) and Its Related Risks	162

LIST OF ABBREVIATIONS

AAOIFI	: Accounting and Auditing Organization for Islamic Financial Institutions
ABS	: Asset Backed Security
AESI	: HSBC/ Nasdaq Dubai UAE US Dollar Sukuk Index
AFIB	: Alternative Finance Investment Bond
AUM:	: Assets Under Management
BHSI	: HSBC/ Nasdaq Dubai Bahrain US Dollar Sukuk Index
CCASG	: The Corporation Council for the Arab States of the Gulf
CRA	: Credit Rating Agency
DIFX	: Dubai Islamic Finance Exchange
DMS	: Dimson-Marsh-Staunton
E&Y	: Ernst & Young
EURO	: The <i>Euro</i> exchange rate
FZCO	: Free-Zone-Company
GCC	: The Gulf Cooperation Council
GLS	: Generalized Least Squares
GSKC	: HSBC/ Nasdaq Dubai GCC Corporate US Dollar Sukuk Index
GSKF	: HSBC/ Nasdaq Dubai GCC Financial Services US Dollar Sukuk Index (GSKF)
GSKI	: HSBC/ Nasdaq Dubai GCC US Dollar Sukuk Index
HASI	: HSBC/ Nasdaq Dubai Amanah US Dollar Sukuk Index
HQRs	: Dow Jones Sukuk Higher Quality Total Return Index
IDB	: Islamic Development Bank
IFI	: Islamic Financial Institutions
IFIR	: Islamic Funds & Investment Report
IFSB	: Islamic Financial Services Board
IIF	: The Institute of International Finance
IMF	: International Monetary Fund
IPO	: Initial Public Offering
IRRs	: Dow Jones Sukuk Interest Return Index
JAFZ	: Jebel Ali Free Zone

KPMG	: Klynveld Peat Marwick Goerdeler
KSA	: Kingdom of Saudi Arabia
LIBOR	: London Interbank Offered Rate
M3TRs	: Dow Jones Sukuk 1-3 Year Total Return Index
M5TRs	: Dow Jones Sukuk 3-5 Year Total Return Index
M7TRs	: Dow Jones Sukuk 5-7 Year Total Return Index
MARC	: Malaysia Rating Corporation Berhad
MENA	: The Middle East and North Africa
MISC	: Malaysia International Shipping Corporation
MYSI	: HSBC/ Nasdaq Dubai Malaysia US Dollar Sukuk Index
OIC	: The Organization of Islamic Cooperation
OLS	: Ordinary Least Squares
PPP	: Public Private Partnership
RAA	: Ram Rating Agency
Rf	: Risk Free Rate
RIRs	: Dow Jones Sukuk Total Return Index (ex-Reinvestment)
SABIC	: Saudi Basic Industry Corporation
SAR	: Saudi Arabian Riyal
SDLT	: Stamp Duty Land Tax
SDR	: Special Drawing Right
SESRIC	: The Statistical, Economic and Social Research and Training Centre for Islamic Countries
SKBI	: HSBC/ Nasdaq Dubai US Dollar Sukuk Index
SKIX	: HSBC/ Nasdaq Dubai US Dollar Nasdaq Dubai-Listed Sukuk Index
SMB	: Size Risk Factor
SPV	: Special Purpose Vehicle
SUCI	: HSBC/ Nasdaq Dubai Corporate US Dollar Sukuk
SUFI	: HSBC/ Nasdaq Dubai Financial Services US Dollar Sukuk Index
SUSI	: HSBC/ Nasdaq Dubai Sovereign US Dollar Sukuk Index
SUSI	: Sovereign sukuk index
TID	: The Investment Dar
TOL	: Tolerance
UAE	: United Arab Emirates

UK	: United of Kingdom
USA	: United State of America
VaR	: Value-at-Risk
VIF	: Variance Inflation Factor
WIFFMC	: The World Islamic Funds & Financial Markets Conference
Δ CCI	: Change in Consumer Confidence Rate
Δ CPI	: Change in Inflation Rate
Δ DOR	: Change in Dollar Rate
Δ HQR	: Change in Operational Risk
Δ IRD	: Change in Interest Rate
Δ MPR	: Change in Maturity Risk
Δ RIR	: Change in Liquidity Rate
Δ SMB	: Change in Credit Risk
tn	: Trillion
mn	: Million
bn	: Billion

CHAPTER ONE

INTRODUCTION

1.1 Introduction

The first chapter provides the introduction of this thesis. Section 1.2 presents the background of a study which explains the importance of Islamic financial markets and its growth and the global evolution of sukuk market and its related problems. Section 1.3 presents problem statement of this study based on supporting previous empirical evidences. Research question and research objectives are provided in Section 1.4 and Section 1.5 respectively. Then, the significances of the study in several ways are discussed in Section 1.6. Finally, section 1.7 covers the scope and limitations of this study are also included in this chapter.

1.2 Background of Research

The Islamic financial market is fast growing and expanding despite the recent financial crisis that swept through the global financial market. In the past, even Muslim countries were reluctant to accept Islamic finance, but, now the situation has changed (Oakley, 2009).

According to SESRIC¹, the 57 Muslim countries are growing at a higher rate than the rest of the country in the World. As these countries grow and modernize, banking and financial sector will grow as well, but in line with the Islamic principles. Woodruff (2007) reported that major financial centers around the world have also adopted the Islamic financial system. They are in competition among them to accommodate

1. Organization of Islamic cooperation (OIC) has a subsidiary of the statistical, economic and social research and training center for Islamic countries (SESRIC) that has started its work in Tripoli in 1977 and Ankara 1978.

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