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Assessment of Sharia-Compliant Risk Management Framework for Sukuk

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Abstract

This study critically examines the *Shariah*-compliant risk management framework of *Sukuk*, a prominent Islamic financial instrument used to mobilize capital for diverse economic ventures. Risk occupies a central role in Islamic finance, serving as a key differentiator between lawful and unlawful profit. While *Sukuk* offer asset-backed, interest-free alternatives to conventional bonds, they are not immune to multifaceted risks, ranging from *Shariah* non-compliance and legal ambiguities to market, credit, and operational challenges. Employing a qualitative research approach, the study is grounded in the content of secondary data drawn from academic literature, institutional reports, *Shariah* standards, and regulatory frameworks. The analysis categorizes the risks associated with *Sukuk* and evaluates both general and specific strategies for their mitigation, including feasibility studies, *Shariah* governance, diversification, cooperative insurance (*takaful*), and regulatory harmonization. The findings reveal that while *Sukuk* are generally considered lower-risk instruments due to their asset-backing and risk-sharing nature, the effective management of *Shariah* and legal risks is crucial for their sustainability and credibility. The study underscores the importance of strengthening *Shariah* compliance mechanisms, enhancing legal frameworks, and developing robust risk management protocols tailored to different *Sukuk* structures. The main recommendation calls for the integration of standardized *Shariah* governance, institutional capacity-building, and the development of an active secondary market to improve liquidity and investor confidence. This research contributes to a deeper understanding of *Sukuk* risk dynamics and offers practical insights for policymakers, issuers, and investors seeking to enhance the resilience of Islamic capital markets.

Keywords: *sukuk, risks, methods, controlling.*

1. Introduction

In recent years, the Islamic financial industry has experienced a remarkable surge in growth and has garnered an unprecedented level of trust, particularly following the global economic crisis. This newfound prosperity has not only instilled confidence in Islamic finance but has also given rise to a pressing need for financial instruments capable of financing major projects and enhancing liquidity in the market. It is in this context that *Sukuk* has emerged as an ideal solution, satisfying the demands and inquiries of both investors and the global financial ecosystem. However, it is essential to recognize that engagement in economic activities within the framework of the Islamic financial system inherently carries a distinct set of challenges and risks compared to conventional, interest-based economies. The cornerstone of Islamic finance lies in the principle of risk-sharing, where both profits and losses are shared among the parties involved. This stands in stark contrast to the non-Islamic model, which revolves around capital guarantees and interest-based returns. As the Islamic financial industry continues to expand and diversify, it necessitates a specialized approach to risk management within the context of *Sukuk*. Islamic financial engineering now shoulders the added responsibility of addressing and mitigating the risks associated with *Sukuk*, which can take various forms based on the specific structure of the *Sukuk*. Moreover, *Sukuk* compositions involving multiple contracts exhibit distinct risk profiles compared to simpler sukuk structures grounded in a single contract. These disparities in risk are further compounded by the

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heterogeneity of assets underlying *Sukuk*, encompassing both tangible and intangible assets, as well as services and benefits. It is imperative to acknowledge that absolute risk elimination is an unattainable objective in any economic system. Risk is an inherent element of financial transactions, permeating all aspects of economic life. Nonetheless, the paramount goal is not to eliminate risk entirely, but rather to implement effective strategies for its management and mitigation, safeguarding the interests of all stakeholders involved in sukuk transactions. This paper embarks on an exploration of these risks within the Islamic financial landscape, seeking to illuminate the nuances of risk management, and thereby, contribute to the stability and integrity of *Sukuk* as a pivotal financial instrument within the Islamic finance domain.

The research aims to assess the significance of risk management in the context of Islamic financial systems and its impact on the sustainability and growth of *Sukuk*, identify the principal risks inherent in *Sukuk* and examine their sources and underlying causes, and to investigate and evaluate the various instruments and strategies employed for the management and mitigation of *Sukuk*-related risks.

This study declares the significance of risk management in Islamic financial systems which is crucial for maintaining the growth and integrity of sukuk. Risk management plays a key role in ensuring stability, adherence to *Shariah* principles, and fostering investor confidence. The primary risks linked to *Sukuk* encompass market risk, credit risk, liquidity risk, operational risk, *Shariah* compliance risk, legal and regulatory risk, and asset performance risk, each stemming from distinct sources or triggers. A range of financial instruments and strategies, including *takaful*, currency swaps, profit rate swaps, asset diversification, and *Shariah*-compliant derivatives, are employed to effectively manage and mitigate these risks (Jamel, 2022).

2. Literature Review

Sukuk is the plural of *Sakk* (صك), meaning a ‘severe beating’ which is derived from the verse in the Holy Qur’an: “ *Then his wife came forward with a loud voice, she smote her own face, and said: "A barren old woman"* (*Surah Adh-Dhariyat*; 29). The word ‘*sakk’* in this verse means ‘strike’ or ‘beat’. However, ‘sakk’ was also mostly used in the Middle Ages to refer to ‘certificates’ or ‘papers’ denoting financial obligations from commercial activities. *Sukuk* is a term according to traditional Islamic jurist Imam Al-Nawawi who noted: “*it is a document to prove a right or a loan*” (Al- Nawawi, 2009). , it is defined by the contemporary Muslim scholars too who accept the comprehensive definition of AAOIFI as: “*Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.”* (AAOIFI, 2017).

i. Types of *Sukuk*

In theory, all *Sukuk* represent a form of equity as they represent a certificate conferring to holder’s ownership of an asset or a pool of assets or a claim to its cash flows. In practice, there are various classification of sukuk from different perspective, the most common are rely on the following bases: *Sukuk* based on the underling *Shariah* contracts which includes sale-based, lease-based, partnership-based, *wakalah*-based and hybrid *Sukuk* based on technical and commercial features which includes nature of the issuer, underlying asset, complexity of structure other additional features. There is also*Sukuk* based on the nature and type of assets which combines debt or receivable *Sukuk*, tangible assets, intangible assets, usufruct and services, and rights in investment projects (ISRA, 2017). The AAOIFI has extensively outlined the various asset classes, which include almost 14 types of sukuk.

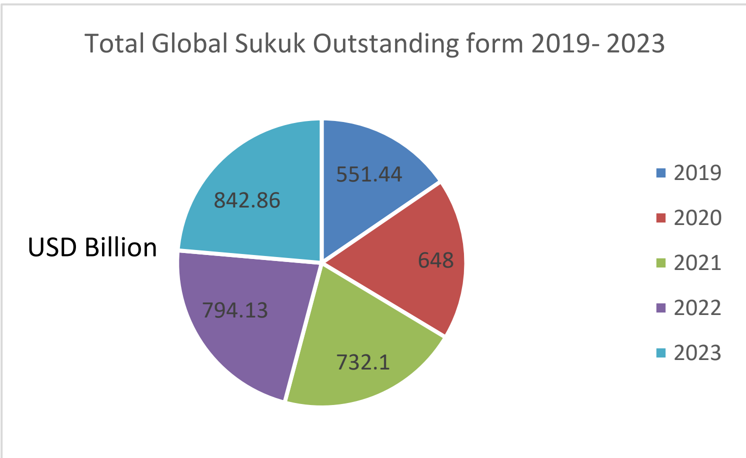
ii. The parties of the *Sukuk*

Even though, each structure of *Sukuk* has its parties but the most common parties for *Sukuk* are issuer SPV, *Sukuk* holders, originator, obligor, *Shariah* advisers, *Shariah* approving authority (formal authority or centralized body who has the responsibility to approved *Sukuk* formally such as SAC and SC in Malaysia (ISRA, 2017). Other key stakeholders may include arrangers, bookrunners, underwriters, trustees, rating agencies, legal counsel, external auditors, and asset custodians, depending on the structure of the *Sukuk*.

iii. The role of *Sukuk* in economic development and risk reduction

Sukuk is a unique product of the capital market and has its own structure and features which are different from other products like conventional bonds and shares (Rubaiyat & Burehan, 2020). Sukuk is an important Islamic instrument for financial intermediation that contribute to achieving economic development through their ability to mobilize financial resources to finance large development projects such as infrastructure projects such as oil and gas, roads, train stations, ports, airports, and others, as well as to finance capital expansions of companies (Shirian, 2013). It also contributes significantly to eliminating poverty, increasing the level of employment, putting idle funds to work, supporting the general budget, and fulfilling the desires of both investors and savers alike. It should be mentioned that, if the *Sukuk* are compared to bonds, it will be known that *Sukuk* are less risky compared to bonds because the most important strategy for managing risks is distributing them to a wide segment of investors, which is represented by the instruments, as for the loan, it is obligatory to pay, which means that the state, company, or financial institution bears all the risks alone (Al-Amari, 2017). On the other hand, *Sukuk* is also not exposed to interest rate risks, as they do not deal with it at all, and is not exposed to inflation risks either, but rather is affected by inflation positively, because the *Sukuk* represent real assets in the form of assets and services, the prices of which rise with the rise in the general level of prices, which leads to an increase in the returns on the *Sukuk* representing those assets (Mahmoud & Shuaib, 2015). Development of *Sukuk* and its rapid growth in recent years have proved the validity of the Islamic financial system and its ability to meet modern business and challenges, but maintaining this growth may be impossible without proper risk management of the *Sukuk* structure. Outstanding global sukuk as at the end of 2023 maintained double-digit growth (+11.2%) to USD794.13 billion, despite lower issuances during the year amid global tightening of monetary policy. The chart 1 below shows the outstanding of global *Sukuk* all over the world.

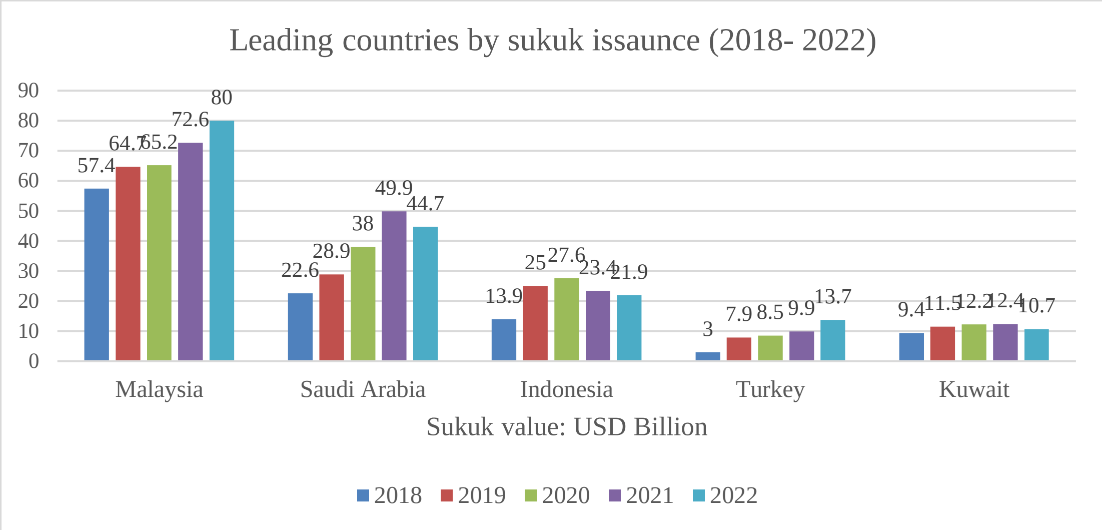
Chart 1: The outstanding of Global *Sukuk* all over the world



Source: IIFM (2024)

While Malaysia remains the world's largest issuer of *Sukuk*, **Saudi Arabia** is also a top scorer in terms of total issuance as well as average issuance size, so the chart 2 below illustrates the ranking of the five top issuer countries in all over the world.

Chart 2: Top five issuer countries of sukuk in all over the world



Source: Refinitiv (2022)

3. Definition of Risk

Risk, in its literal meaning, denotes uncertainty between two options: potential destruction or similarity. In the terminology of *fiqh* jurists, it is used for two meanings: in the sense of gambling, and in the sense of the possibility of profit or loss in trade resulting from market events and price fluctuations, not the original contract. This is what Ibn Qayyim Al-Jawziyyah mentioned: "*there are two types of risk: the risk of trade, which is buying a commodity with the intention of selling it and making a profit and relying on Allah SW in that, and the second risk is gambling which involves consuming money unlawfully*" (Ibn al Qayyim, 1994). According to economists, risk is the possibility of loss by the investor (Sawa, 2016), or risk is usually measured as a standard deviation or variation of outcomes, and as a result, the risk is uncertainty of future outcomes.

4. The Relationship between Investment and Risk Tolerance from the Shariah Perspective

Islam recognises that risk can never be entirely eradicated; however, it allows and encourages its reduction through different preventive measures and this is the aim of Islamic financial securities (Khan & Saeed, 2020), So there is a robust relationship between Islamic investment and risk-bearing, and this correlation between them is due to the investor's risk-bearing being the most important characteristic of Islamic investment that distinguishes it from a usurious transaction guaranteed to return interest to the lender. There is a *fiqh* maxim, which states that everything that is obtained in terms of gains is entitled to bear the responsibility for the loss or damage in the case it occurs from *Shariah* perspective (Al-Tirmidhi, 1998). The origin of this maxim is the *hadith* narrated by Aisha (PBH), that a man bought a slave and took advantage of him, then he found a defect in him and returned him to the seller, and the seller said: "*O Messenger of Allah (SW), he has taken advantage of my slave*". The prophet (PBUH) said: "*bearing the loss is due to gaining benefit"* (Al-Sijistani, 2009). Considering this *hadith*, the *fiqh* jurists formulated the well-known general maxim which means that: *whoever suffers a loss/damage deserves a profit* (Al-Zuhaili, 2006). It will be extracted from this *Shariah* maxim that if the risks are naturally absent or if some mechanisms are used to move the risk, then the investment is not permissible, so according to *Shariah* every transaction must include risk (Ibn Ashour, 2001). It is worth noting that the concept of risk in *Shariah* differs from its meaning in economics, the risks in *Shariah* are related to the nature of investments, and in the economy are related to economic conditions, political events, and environmental factors that lead to fluctuating returns on investment that are marred by uncertainty (Sawa, 2016). Risk in Islamic finance has its unique attributes and distinctive characteristics, it does not mean the possibility of harm and adverse impact at all, instead, it will decrease the burden on contractors, unlike conventional contracts, which put all damages on the loser at the beginning (Khan & Saeed, 2020). *Shariah* jurists have used the concept of risk into two directions: the permissible direction and the forbidden direction, and the meaning of risk in the permissible direction is bearing the results of the investment process for both parties to the contract and the principle of parity is achieved in it, and this is indicated by the mentioned maxims. The concept of risk in this direction is the performance of specific and *Shariah* legitimate actions by the investor by placing money in an investment project in any of the *Shariah* contracts, bearing the consequences of that project, whether profit or loss. From this standpoint, we see in *Sukuk* that investors (*Sukuk* holders) offer their money at risk and bear the consequences of the *Sukuk* process. This confirms the principle of equality and reciprocity between loss and profit in sharia and the entitlement to profit in it in preparation for bearing loss as well (Iyad, 2020). There are many examples in *Shariah* that indicate the necessity of risk in work and business, that the Messenger of Allah SWT, said that "*you must pay the wage of worker before his sweat dries up*" because he has accepted the risk and now he has to get the benefit as well (Al-Bayhaqi, 2011), As for the risks in the forbidden direction, it is taking risks and undertaking something whose existence is not known and hesitating between existence and non-existence regarding obtaining a profit or not, and this involves deceiving investors. This type of risk leads to unlawful consumption of people's money, sin and aggression, and does not involve the principle of equality (Iyad, 2020). Islamic *Shariah* approves the first direction, which is permissible because of the equality between the parties in the investment process and equality in the gains and losses (Zakariyah & Syllah, 2020).

5. Causes and Various Types of Risks Related to the Sukuk

It should be mentioned that the risks to which the *Sukuk* are exposed differ according to the structure of the *Sukuk*, for instance the risks of *Murabaha Sukuk* are different from *Musharaka Sukuk*, and the risks of *Istisna Sukuk* are different from *Ijarah Sukuk* and so on. These risks also vary depending on the assets that make up the *Sukuk*, such as fixed, non- moveable/ movable assets, benefits and services, and there are some other risks which the *Sukuk* are exposed like legality risk, operational risk, market risk, capital market risk, inflation risk, securities risk, credit risks and liquidity risk, it can be said that, since sukuk is not structured without *Shariah*, economic and legal controls, violating them is considered a risk, so there are many risks that have been identified while reviewing the literature (Jamel, 2022) in general the risks of *Sukuk* can be abstracted in the following elements:

5.1. Shariah Non-Compliance Risk

This is the risk to which Islamic financing instruments are exposed, which are represented in violating *Shariah* standards in investment activity and violating the nature of the financing instruments on the basis of which Islamic investment *Sukuk* is issued for example, One of the risks that is considered a violation of *Shariah* standards in benefits and services sukuk is the trading of *Sukuk* of ownership of services that are fulfilled by a party described in the liability before appointing the party from whom the service is to be gained. And the trading of ownership *Sukuk* for the benefits of the assets described in the liability before specifying the property from which the benefit is derived (AAOIFI, 2017). Also, this kind of risk include contradiction to the sharia provisions, as *Sukuk* is a *Shariah* financial instrument, it must be dealt with and traded within the framework of specific and controlled provisions, and based on complete and partial evidence, and general and specific sharia objectives. Therefore, the violation of the *Sukuk* to these *Shariah* provisions at any stage leads to the invalidation of the *Sukuk* in whole or in part, or the annulment of the transaction because of the illegality that occurs in process of the securitization. There are many forms of violation of *Shariah* rules in *Sukuk*, and it is impossible to enumerate and restricted them in this article. Each *Sukuk* structure has its own *Shariah* principles and rules, and the violation of which is one of the risks which must be studied and the possibility of occurrence, how to be restricted, and ways to address them. For example, if Islamic financial institutions borrow mortgages from their clients, if they securitize these mortgaged assets in the form of *Ijarah* or *Musharakah Sukuk* or other possible forms of securitization, this type of *Sukuk* is invalid, because the institution sold to the *Sukuk* holders what it did not own, which is one of the prohibited sales in *Shariah*. Utilizing the *Sukuk* proceeds in forbidden purposes such as forbidden goods and services, usury, gambling, deception, fraud, deception and/or betrayal is not acceptable (Sawa, 2016). Perhaps one of the most prominent elements of *Shariah* risks is the weakness of *Shariah* supervision in some Islamic financial institutions. However, this type of risk varies in strength and weakness from country to country, and financial institution to another. The analysis of this risk is so important considering criticism by some Muslim scholars regarding non-Islamic nature of some of the *Sukuk*. Therefore, the issuing Islamic financial instruments non-compliant with *Shariah* is very damaging to the reputation of issuer and may require extensive efforts to regain the confidence of investors (Alswaidan, 2017).

5.2. Legal and Regulatory risk

It is evident that every financial product and instrument, including *Sukuk*, requires proper regulation to maximize its benefits. However, *Sukuk* markets remain underdeveloped and lack uniform standardization globally. Therefore, lack of the standardized regulations governing the Islamic finance is a major impediment to further development of the whole market, including *Sukuk*, also lack of clarity about the financial contracts implemented in the *Sukuk* leads to the emergence of legal risks, they are linked to the statute, legislation, and supervisory orders that govern compliance with contracts and transactions (Iyad, 2020). The nature of these risks may be external, such as supervisory controls that affect some types of activities practiced by banks or they may also be of an internal nature related to the bank's management and its employees, such as Fraud and non-compliance with controls and laws. The legal system of many Islamic countries is not consistent in many aspects with the *Shariah* rules, especially the laws of money, loans, the collection and taxes, and many provisions of civil law, which makes the process of *Sukuk* exposed to great difficulties, especially in drafting the necessary contracts for the process, and the issue even become more difficult if it transferred to the courts, where there is the ruling of statues laws not *Shariah* (Alswaidan, 2017).

5.3. Operational and management risk

It is related to functional dysfunctions in transaction systems, reporting systems, and risk monitoring rules. This type of risk is mostly derived from the weak financial infrastructure in which sukuk are issued and traded (Mahmoud & Shuaib, 2015).

These risks arise because of human errors, technical errors, or accidents, for instance, the structures of tradable sukuk must be based on assets, and the return on this type of sukuk comes from these assets, and the operational risks of these assets must be carefully studied. For example, we know that the rental return in *Ijarah Sukuk* is the return of the *Sukuk*, if the benefits of the rented property are suspended, so the tenant does not have to pay the rent; as a result, the *Sukuk* will not have any return. Thus, it is evident that rental estate-based rental *Sukuk* carries a lower risk of return loss due to benefit disruption than the *Sukuk* back by vehicles, factories, airplanes, or ships (Dwabah, 2016).

5.4. Market risk

The instruments and assets that are traded in the market are considered the source of this type of risk. This is either for reasons related to macroeconomic variables or because of the conditions of institutions and banks. We can say that the general market risks are the result of general changes in prices and policies at the level of the economy, and special market risks arise when there is a change in the prices of specific assets and traded instruments, because of special circumstances (Gharbi & Jabalahi, 2018). These risks include general risks, as they are due to the ups and downs trends that occur in the markets due to economic, social, or political factors, whether they are real asset markets, or financial markets, which consist of Money markets and capital market which includes both, issuance market and the trading market (Dwabah, 2016).

5.4.1. Real Asset Market Risk

All *Sukuk* issues should be backed by tangible assets, but there are some difficulties in identifying the appropriate underlying asset and the main asset used for *Sukuk* issuance is a real asset; it should meet *Shariah* requirements and be able to provide attractive returns (Ola, 2013). These risks are related to the nature of *Sukuk* as they represent a common share in the ownership of assets, and since the real assets including goods and services are sold in the markets, they may be exposed to a decrease in their value due to factors of supply and demand, or government economic policies, and other market factors (Bittar, 2015).

5.4.2. Capital Market Risk

This type of risk can be classified according to the following:

i. Exchange rate risk: This risk arises in the money market because of currency exchange rate fluctuations in futures transactions. If goods are purchased in a foreign currency and the price of that currency decreases, this will result in losses to the extent of the decrease in the price of the foreign currency against other currencies (Abu Umar, 2019).The exchange rate risks also appear when issuing sukuk in a specific currency and investing their proceeds in other currencies, or if the issuing institution of sukuk maintains open positions towards some foreign currencies or payment obligations, especially in Murabaha and international trade operations (Barqawi, 2018).

ii. Interest rate risk: This risk arises because of changes in the level of interest rates in the market in general, and they affect all investments regardless of the nature and circumstances of the investment itself. Generally, with other factors remaining the same, whenever the levels of interest rates increase in the market, the market value of the securities decreases, and vice versa, which affects the rate of return on investment (Hindi, 2016). Even though Sukuk are not directly affected by the interest rate, in their activities and areas of investments, because they are not dealt with, they may be affected by the interest rate if they take it as a reference rate in *Murabaha* financing, such as LIBOR (Ali Arsalan, 2006).

iii. Securities risk: This risk arises because of fluctuations in securities prices in the capital markets, whether these fluctuations are due to real factors, or artificial and immoral factors such as rumors, monopoly, gambling, embarrassment, fake buying and selling, and so on, which affects the market value of Islamic *Sukuk* (Roslen & Zaghlol, 2022).

iv. Inflation risks: These systematic risks arise because of the decrease in the purchasing power of money due to rising prices, which means that the invested funds are exposed to a decrease in their real value. As *Sukuk* has a variable return and consists of money, debts, assets, and benefits, its vulnerability to inflation is directly related to the increase in its money and debt components (Ali Arsalan, 2006).

5.5 Credit risks of sukuk

This type of risk of sukuk is as follows:

i. Risk of delay in fulfillment: If investors expect that the returns on the sukuk distributed to them will be delayed several months due to the debtor's desire to delay payment, they will be disappointed, which will not only affect the prediction of the assets' ability to repay, but this will reflect negatively on confidence in the securitization deals (Barqawi, 2018).

ii. Risk of default: This risk depends on the creditworthiness of the debtor, as the debtor is unable to fulfill his contractual obligations in full and on time, and it is considered a very weak risk for *Sukuk* (Khan & Saeed, 2020).

iii. The client's failure to fulfill his contractual obligations in full on the due date: The source of these risks may be the result of the client's poor choice, whether by not fulfilling the obligations of the work assigned to him for investments in the *Musharaka Sukuk, Mudaraba, Mazara, Musaqat, Mugharasa* and *Istisna'*, or his unwillingness to receive the commodity purchased. It could also be his desire to renege on his promise to invest in the *Murabaha Sukuk*, or his unwillingness to receive the manufactured commodity in the *Istisna Sukuk* investments. Another possible cause is the customer's failure to fulfil his obligations under *Murabaha Sukuk* and *Ijarah Sukuk* investments, failure to supply goods as specified for *Salam Sukuk* investments, or the customer's incompetence, poor financial standing, or bankruptcy (Badroni, 2018).

5.6 Risk of securitization of sukuk for real assets

The risk is that investors expect that these assets will not be able to generate sufficient cash flows to distribute the expected returns to the holders of the *Sukuk* that were specified in the prospectus, which would negatively affect investors' confidence in those sukuk. This risk can be averted by conducting comprehensive studies on securitized assets, accurately estimating their cash flows, and performing a sensitivity analysis on them to discover the dangers and put in place the necessary measures to avert the risk, including insurance on those assets (Barqawi, 2018).

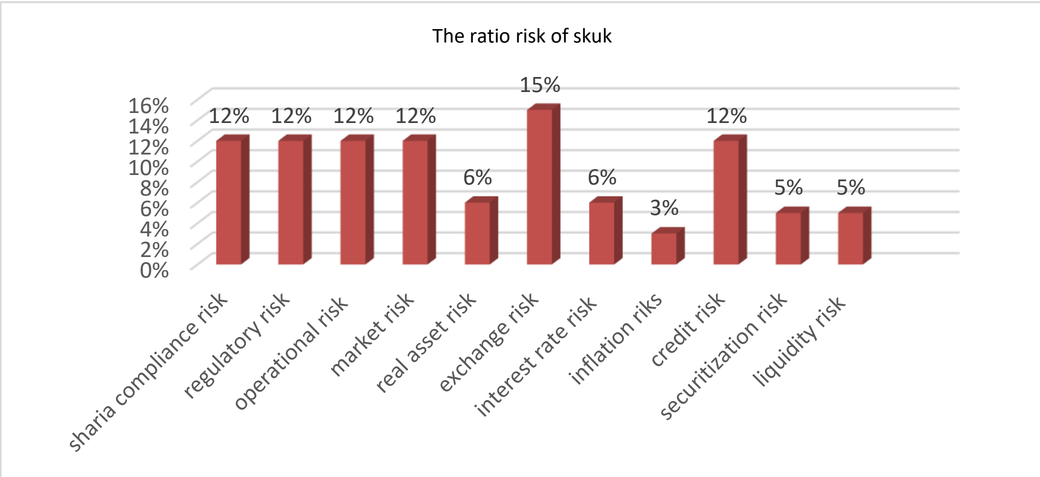
5.7 Liquidity risk

Liquidity is vital for International Financial Institutions (AFA), particularly for Sukuk as it is difficult for them to manage their liquidity, due to *Shariah* restrictions on trade of debt and other securities, and as short-term interbank lending is not available because of the existence of *riba,* With the exception of Malaysia who has developed interbank lending based on profit and loss sharing. This type of risk is related to the issuer of the *Sukuk*, and not to its counterparty, as it appears when the issuer is unable to meet its obligations for *Sukuk* payments on time in an effective manner due to insufficient liquidity - to meet normal operating requirements, or to pay periodic returns to *Sukuk* holders, or to pay the increase in the value of the *Sukuk* at maturity - as a result of the project's cash flows suddenly declining, which reduces the issuer's ability to fulfill its obligations that have come due (Bittar, 2015).

6. Conceptual Framework

Whereas the paper aims to explain the risks of sukuk and its mechanism to control them from the *Shariah* perspective, the chart below illustrates the ratio rate of the risk for the *Sukuk.*

Chart 3: The ratio rate of risk for the sukuk



Source: Roslen & Zaghlol (2022)

7. Research Methodology

This study adopts a qualitative research approach to explore and assess the *Shariah*-compliant risk management framework specific to *Sukuk*. Given the complexity and multifaceted nature of risks in Islamic financial instruments, particularly *Sukuk*, the qualitative method provides a suitable platform to capture the conceptual, regulatory, and *Shariah*-related dimensions of risk management comprehensively and contextually. The research primarily relies on secondary data sources, including peer-reviewed journal articles, regulatory standards (such as AAOIFI and IFSB guidelines), industry reports, and relevant legal and *Shariah* literature. These documents were selected based on their relevance, credibility, and contribution to understanding the theoretical and applied dimensions of *Sukuk* risks. Data triangulation was employed to ensure the validity and reliability of interpretations. To analyze the collected data, the researchers utilized a thematic content analysis, focusing on identifying, categorizing, and interpreting key types of risks (e.g., Sharia non-compliance, operational, credit, and market risks) and their mitigation mechanisms within *Shariah* parameters. The analysis also considers general and specific risk-control strategies, such as *Takaful*, diversification, feasibility studies, and legal structuring, aligning them with Islamic jurisprudential principles. The study further integrates conceptual mapping to illustrate the relationship between risk categories and the tools used to mitigate them, highlighting the distinctiveness of Islamic finance in handling financial uncertainty through shared risk and ethical constraints. Ultimately, the qualitative methodology enables a deep examination of how Islamic financial institutions manage *Sukuk*-related risks while maintaining compliance with *Shariah*, thereby enhancing investor confidence, financial integrity, and sustainability of Islamic capital markets.

7.1. Data Analysis and Content Analysis Discussion

This study employs content analysis as a systematic method to interpret and categorize textual data related to the risks and Sharia-compliant risk management frameworks associated with *Sukuk*. The primary sources analyzed include regulatory standards, AAOIFI and IFSB, academic literature, fatwas, institutional reports, and empirical studies from reputable Islamic finance bodies and scholars. Through this approach, the study identifies recurring patterns, concepts, and terminologies central to the discourse on *Sukuk* risk management. The analysis categorizes risks into thematic groups such as *Shariah* non-compliance, legal and regulatory risks, credit and market risks, asset-related risks, and operational challenges. Each category is further examined for its underlying causes, frequency of mention in the literature, and the diversity of mitigation strategies proposed.

Shariah non-compliance emerges as a dominant concern in the literature, frequently linked to weak governance structures, misapplication of contracts, or a lack of unified *Shariah* interpretations across jurisdictions. The study highlights how this risk is addressed through mechanisms such as Shariah Supervisory Boards, standardization efforts by AAOIFI, and enhanced documentation protocols. Similarly, legal and operational risks are consistently discussed in the context of jurisdictional fragmentation and insufficient legal recourse for enforcement action, particularly in cross-border *Sukuk* structures. The content analysis reveals a growing emphasis on the need for regulatory harmonization and the development of robust legal infrastructures tailored for Islamic finance.

By critically synthesizing the textual content across diverse sources, this analysis enables a comprehensive understanding of both the conceptual and practical dimensions of risk management in *Sukuk*. It also helps identify knowledge gaps and inconsistencies in practice, providing a foundation for further empirical inquiry and policy recommendations aimed at strengthening the *Sukuk* ecosystem.

7.1.1. General methods

There are some ways to treat the risks of *Sukuk* generally, including sharia, economic, and technical methods. We can categorize them into two parts: general methods, which contain all types of risks, and private methods, which contain particular risks to manage.

Feasibility study: Studying the feasibility of the projects to which the funds from the sukuk proceeds are directed is of great importance to reduce and even avoid risks as much as possible, as evaluating the feasibility of the project from an Islamic perspective is governed by what can be called (Islamic profitability) by directing funding towards projects committed to Islamic legitimacy in terms of halal activity (Bourahli, 2019). As well as economic efficiency, to achieve optimal allocation of resources through saving and developing money. Observing the Islamic priorities in investment according to necessities, needs, and beautifications, and always following up with clients (Iyad 2020). All of these would contribute to reducing the risks of sukuk in general.

7.1.2. Efficiency of management and monitoring

The efficiency of *Sukuk* management is considered the essence of their profitability and growth, and the more efficient the management is, the more these *Sukuk* combine the dilemmas of profitability, liquidity, and security, in addition to considering ethical considerations and social responsibilities. Islam urges the manager to combine ethical and technical aspects. It also urges the proper selection of partners, *Mudarib*, and workers who are competent and known for their good morals. One of the factors for reducing risks is giving the *Sukuk* holders the right to monitor the management through a general assembly that represents them, taking into account that in the *Mudaraba Sukuk*, the sukuk holders are not permitted to interfere in the management except in some conditions, although they have the right to follow the actions of the *Mudarib* to ensure his compliance with the conditions of the *Mudaraba* (Badroni, 2018).

7.1.3. Establishing an Accounting and Auditing System (AAS) for issuing and trading Sukuk

The AAS has a significant impact on managing the risks from all dimensions, it must be an independent, strong, and efficient system, and robust investment appraisal as well (Iyad, 2020). Measuring and determining the degree of risk: The entity that manages the risks must be aware of the nature of the risks to which the sukuk are exposed, by measuring the risks to determine whether their degree is high or low to prepare to bear them because the concept of risk has no value from a scientific standpoint if it is not capable of measuring and classifying risks in a way that enables one to identify their degree (Dwabah, 2016).

7.1.4. Establishing and developing secondary markets

Having developed appropriate secondary market is very crucial to decrease the risk of liquidity because high demand of *Sukuk* require enough supply, in this case the government should be active to issue variety of maturity of risk bearing sukuk like short term maturity sukuk and provide suitable regulatory standards for transparent and sound in secondary market (Hasangholipoure, 2021).

7.1.5. Appointment of the (SSB) Sharia Supervisory Board

This is to ensure compliance with the provisions of Sharia, which is through the formulation of *Shariah* contracts on which the Sukuk is based upon issuance, and work procedures to ensure their compliance with *Shariah* regulations. *Shari'a* Supervisory Boards (SSBs) certify *Sukuk* instruments with a *fatwa* and play a vital role in managing such risk. To avoid the risk of violating the provisions of *Shariah*, Islamic financial institutions must appoint a Sharia Supervisory Board to supervise all necessary steps for dealing with *Sukuk* (Al-Amari, 2017).

7.1.6. Guarantees

There are many types of guarantees in Islamic economic thought through which the risks of *Sukuk* can be dealt with, including the guarantee (*kafalah*), which is through the commitment of one party to bear the burden of another party as a donation. The guarantee of the wealthy person is an effective means of reducing the risks of investing the proceeds of the *Sukuk*, especially the credit and legal risks and the risks of assets and their returns. A mortgage is also a protection mechanism against risks, especially credit risks. As for the guarantee, whether it is a *kafalah* or a mortgage, it cannot be retracted in trust contracts, such as in *wakalah* investments, *Mudarabah*, or *Musharakah Sukuk*, unless the conditions are transgression, negligent, or violated the condition by the agent, the *Mudarib*, or the participant, as stated in the decision of the International Islamic Fiqh Academic. It is not permissible for the entity to issue the *Mudaraba*, *Musharaka*, or *wakalah Sukuk* to guarantee the nominal value to the sukuk holders, because it is a guarantee of capital, and this is not permissible in trust contracts (Zakariyah & Syllah, 2020).

7.1.7. The state contributing to guarantee capital or profit

The state can announce its commitment to guarantee the capital or a percentage of the profit to the sukuk holders. The state usually contributes to the sukuk holders in a specific project that is in line with its economic plans, so the state should allocate a special budget for this purpose, because it establishes a balance between the various activities.

7.1.8. A third party contributes to guarantee capital or profit

This process is done through the prospectus, stipulating the approval of a third party outside the contract parties to guarantee capital or a certain percentage of profits. It may be an individual or a company with an interest in encouraging a certain type of activity, and there is no sharia obstacle or objection to that, even if it was a contribution contingent/ pending on the condition that all or part of the capital is destroyed or that the profit decreases below a certain limit. The *Shariah* basis for this permissibility is the maxim of obligation of donations (Aznan, 2011).

7.1.9. Mudarib guarantees the capital for the owner voluntarily

If the *Mudarib* volunteers guarantee the capital in the *Mudarabah*, it is permissible under two basic conditions: It is not permissible to mention voluntary work in a *Mudaraba* contract, either explicitly or implicitly, and volunteering takes place after concluding the *Mudaraba* contract, not before (Aznan, 2011).

7.1.10. Cooperative insurance/Takaful

The risks of investing in sukuk can be insured with Islamic cooperative insurance companies/institutions, as a result of the *takaful* and solidarity of others in bearing the risks, this insurance is considered an Islamic mechanism to protect against sukuk risks, even though sometimes the domestic insurance capacity does not cover this volume of risk and the need for external ways to manage the risk (Hasangholipoure, 2021).

7.1.11. Diversification of investments

There are default and return risks for *Sukuk*, but the default risks can be reduced and managed through diversification of portfolios. It means the diversification of *Sukuk* investments is necessary to invest in more than one project to reduce the degree of risk to which the return of the *Sukuk* is exposed (Abu Umar, 2019). The purpose of diversification is to reduce the standard deviation of the total portfolio by increasing the number of securities included in the portfolio. There are different foundations for diversification, the most important of which are issuer diversification, maturity date diversification, sectoral diversification, and international diversification (Nurfaiza, 2023).

The diversity of Islamic *Sukuk* makes them suitable for many different economic sectors and helps reduce risks. For example, Murabaha *Sukuk* is commercial business *Sukuk*, and *Salam Sukuk* is most suitable for financing agricultural projects, extractive industries, and craftsmen, and *Istisna sukuk* is used to finance the construction and infrastructure sector, and *Musharakah Sukuk* is the most suitable for financing all types of long, medium and short-term investments, whether commercial, agricultural or industrial businesses, as well as *Mudaraba Sukuk*, but it is distinguished from *Musharakah Sukuk* in that its separate project management from its ownership (Badroni, 2018).

7.1.12. Treating the risks of Islamic financing instruments

To mitigate these risks, *Sukuk* holders may impose restrictions in the prospectus, such as limiting specific types of trade, a practice allowed under *Mudarabah* contract. They may also require that if the client delays payment, all remaining installments become due, or impose a fine for the delay, provided the fine is directed to a charitable fund and used accordingly and is acceptable under the *Murabahah* contract (Iyad, 2020).

7.1.13. Treating the risks of investment projects

To effectively mitigate the risks associated with *Sukuk* issuance and investment, it is essential to establish robust project standards that collectively guarantee the success and sustainability of the underlying ventures. Central to this process is the notion of *Shariah* soundness, which serves as the foundation for legitimacy in Islamic finance. A project must not only avoid prohibited elements such as riba, *gharar* (excessive uncertainty), and haram activities, but also ensure that its structure and operations uphold the ethical and legal principles of Islamic jurisprudence (Al-Amari, 2017). Without adherence to these fundamentals, the project risks invalidation from a *Shariah* perspective, compromising investor trust and institutional reputation.

Equally critical is the legal soundness of the project, particularly in jurisdictions where the alignment between civil law and Islamic financial contracts remains inconsistent. Legal clarity and the presence of enforceable investment protections are indispensable to ensure that contractual obligations can be upheld under both *Shariah* and national law frameworks.

Furthermore, organizational and administrative efficiency play a pivotal role in risk reduction. Projects lacking competent leadership, clear financial planning, and adequate governance mechanisms are more vulnerable to operational disruptions and managerial failures (Abu Umar, 2019). In parallel, technical soundness, including access to skilled human resources, raw materials, and infrastructure determines the project's capacity to function effectively in its intended environment.

From a financial standpoint, the economic viability of a project must be rigorously evaluated. This entails ensuring a reasonable return on investment that aligns with industry benchmarks, a capital structure that balances risk and reward, and overall financial resilience. Finally, broader economic and social considerations such as employment generation, equitable income distribution, and environmental impact are essential for aligning project goals with the *Maqasid al-Shariah*, reinforcing the ethical mission of Islamic finance (Abu Umar, 2019).

7.1.14. Establishing a reserve fund to confront investment risks

It is possible to establish a reserve fund to confront investment risks with no objections from Shariah to be stipulated in the prospectus, provided that the *Sukuk* holders agree to deduct a portion of their profits each year. This amount is allocated to pay off any shortfall or profit that falls below a predetermined during a particular year (Dwabah, 2016). When viewed as a donation from the capital owner, any surplus beyond the compensation for loss or reduced profit is allocated to a charitable purpose at the end of the project, and the new *Sukuk* owner's consent may be sought for the donation at the time of purchase. The formation of reserves is one of the guarantees that are suitable for dealing with all *Sukuk* risks. For example, a profit rate reserve can be formed from the income of *Mudarabah* funds before deducting the *Mudarib's* share to maintain a certain level of sukuk returns. It is also possible to create an investment risk reserve by deducting a portion of the profits of the sukuk holders after deducting the *Mudarib's* share to protect against future losses that the sukuk may be exposed to (Dwabah, 2016).

7.2. Establishing legal frameworks

Addressing the unique risks inherent in *Sukuk* requires a multifaceted and context-sensitive approach, particularly when dealing with regulatory, operational, and structural vulnerabilities. A critical challenge remains the lack of harmonized regulatory frameworks governing *Sukuk* issuance across jurisdictions. Without a standardized legal infrastructure, inconsistencies in *Shariah* interpretations and contractual enforcement pose significant risks to investor confidence and cross-border *Sukuk* transactions. Although global institutions such as AAOIFI and IFSB have made strides in issuing guiding standards, their adoption remains uneven, with countries like Malaysia, Saudi Arabia, and Turkey developing localized frameworks that may not always align. Therefore, establishing unified legal and regulatory norms is not just advisable, it is imperative for long-term market stability and scalability (Abu Umar, 2019).

In addition to legal risks, foreign exchange volatility introduces another dimension of uncertainty, particularly for cross-border investors. Issuing *Sukuk* in multiple currencies and maintaining diversified investment portfolios serves as a practical strategy to hedge against exchange rate fluctuations and promote greater international participation in *Sukuk* markets. Furthermore, asset-related risks, especially in structures like *Ijarah Sukuk*, demand innovative mechanisms. For instance, allowing the originator or lessee to substitute assets of equivalent value during the *Sukuk's* tenure offers both flexibility and continuity in cash flow generation, thereby reducing exposure to asset depreciation or obsolescence (ISRA, 2017).

Equally significant is the risk governance of the Islamic financing instruments themselves. Be it *Mudarabah, Musharakah, Istisna'*, or *Ijarah* contracts, effective risk mitigation relies on the choice of partners, precise contractual terms, and the suitability of the environment. Operational diligence, such as choosing competent *Mudaribs,* ensuring enforceable lease terms, and carefully vetting manufacturers, can significantly reduce default risk (Hassan, 2020). Moreover, the practice of binding promises to repurchase assets by *Sukuk* managers, under specific conditions and without violating *Shariah* principles, introduces a layer of contingent protection. While not equivalent to capital guarantees, these mechanisms offer practical reassurance to investors, provided they are exercised within the boundaries of non-committal trust-based contracts and only triggered under permissible scenarios.

8. Conclusion

Sukuk has emerged as a pivotal and dynamic Islamic financial instrument, offering a *Shariah*-compliant alternative to conventional bonds and playing a transformative role in financing real economic activities. Its versatility, structural diversity, and alignment with asset-backed financing principles have positioned it as a preferred tool for both deficit units seeking capital and surplus units pursuing ethical investment opportunities. As such, *Sukuk* contributes significantly to financial deepening, infrastructure development, and the broader objectives of Islamic economic justice. However, the rapid growth and increasing complexity of *Sukuk* structures also expose the instrument to a range of risks, both conventional and *Shariah*-specific. Market volatility, operational inefficiencies, credit exposures, and legal and regulatory ambiguities can undermine the integrity and performance of *Sukuk* instruments. More critically, *Shariah* non-compliance risks stemming from improper structuring, weak governance, or misapplication of Islamic contracts pose existential threats to their legitimacy and investor confidence. While empirical evidence suggests that *Sukuk* may be less risky than conventional securities due to their asset-backed and profit-loss sharing nature, risk is inherent and must be systematically addressed.

To ensure the long-term sustainability and resilience of the *Sukuk* market, a proactive and integrated risk management framework is essential. This should include rigorous feasibility studies before issuance, enhanced *Shariah* governance through independent supervisory boards, the use of *Takaful*, deployment of credible guarantees, diversification of *Sukuk* structures and portfolios, and the development of active secondary markets to address liquidity constraints. Furthermore, harmonization of legal and regulatory standards across jurisdictions will be vital in minimizing legal uncertainties and enhancing cross-border investor participation. Ultimately, the effective mitigation of these risks not only safeguards stakeholder interests but also strengthens the role of *Sukuk* as a cornerstone of ethical and inclusive Islamic finance.

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