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The Construct of Sukuk, Rating and Default Risk

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Abstract

This paper discusses the underlying principles of Sukuk. The ultimate objective of the study is to provide an understanding on the fundamental idea of Sukuk, its rating and its implication to default risk. Sources of data include observation, documents and texts, specifically from Securities Commission Malaysia (SC), Rating Agency Malaysia (RAM) and Malaysian Rating Corporation Berhad (MARC), Standard & Poor's report, and authors' analysis on the subject matter. Despite showing consistent growth of issuance across countries, Sukuk may also promote default risk as Sukuk also needs to undergo a credit rating assessment of its future payment prospects. Even though Sukuk issuance comes together with asset security, however any negative migration of the credit rating assessment would indicate default risk.

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1. Introduction

Sukuk represents a value of an asset and frequently referred to as an Islamic bond, but a more accurate translation of the Arabic word would be an Islamic Investment Certificate. The Securities Commission Malaysia (SC) defines Islamic private debt securities (IPDS) as any securities issued pursuant to any Shariah principles and concepts approved by the Shariah Advisory Council (SAC) of the SC (SC, 2004). Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (1999) defines Sukuk as '*certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services in the ownership of particular projects or special investment activity, however, this is true*

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after receipt of the value of Sukuk, the closing of subscription and the employment of the funds received for the purpose for which the Sukuk were issued.

Sukuk, which are compliant with Shariah Islamic law (Wilson, 2004), are an attractive investment instruments for Islamic banks, takaful or Islamic insurance companies and Shariah managed funds that cannot invest in conventional securities that involve payment of riba or interest. Sukuk enhance the stability of financial institutions by providing them with improved portfolio, liquidity, and risk management tools. Furthermore, Sukuk become highly demanded as there are an increasing number of Muslims of high net worth, who want their asset holdings to comply with Islamic law (Wilson, 2008). Recent modernization in Islamic finance has changed the dynamics of Islamic financial industry. The demand for Sukuk or Islamic securities has become increasingly popular in the last few years and has gained universal acceptance as a feasible alternative to conventional financial products. Sukuk have developed as one of the most significant mechanisms to raise finance in the market through Islamically-acceptable structure (Mohamed, 2008). This paper would therefore explore the underlying principles of Sukuk, its rating and default risk implication due to Sukuk rating. The paper is organized as follows; Section two discusses the construct of Sukuk by highlighting the differences between conventional bonds and Sukuk, and elaborating the types of Sukuk and the global development of Sukuk. While Section three discusses the Research methodology, Section four discusses Sukuk rating and default risk. The conclusion of the paper is presented in the last section.

2. Construct of Sukuk

Both Sukuk and conventional bond have fixed term maturity, bear profit (coupon) and are tradable at normal yield price. However, according to Bakar (2008), Sukuk are different from the conventional bond as it represents the undivided shares in ownership of assets, usufruct, projects and services. Sukuk also demonstrate the partnership relationship between the issuer and the investor. Meanwhile, conventional bond is debt obligation, which can be either secured against certain underlying assets or unsecured in the form of promise to pay. In return, the issuer promises the investors to pay back the amount plus interest at its maturity date. In terms of differences between conventional bond and Sukuk; conventional bond is clearly a debt instrument while Sukuk may be debt or equity instruments. In conventional bond, bondholder owns the cash flow rather than the asset in Sukuk. Sukuk encompass variety of contracts to create financial obligations while conventional bonds only issue a contract of loan to create indebtedness. The return derives on bond is linked to interest, which is charged out of the loan contract while the return on Sukuk is linked to profit elements. Sukuk have several types depending on its usefulness. The most important and common among those are Murabahah, Mudarabah, Musharakah, Ijarah, Salam and Istisna'. There are also other diversified and mixed asset Sukuk that emerged in the market such as hybrid Sukuk, where the underlying pool of assets can comprise of Murabahah, Ijarah as well as Istisna'.

In the case of Murabahah Sukuk, the issuer of the certificate is the seller of the Murabahah commodity, the subscribers are the buyers of that commodity, and they are entitled to its final sale price upon the re-sale of the commodity. The issuer's obligation is to settle the purchase price, which is securitized via the issuance of Murabahah notes (Dar and Azami, 2010). Murabahah Sukuk cannot be legally traded at the secondary market, as the certificates represent a debt owing from the subsequent buyer of the commodity to the Sukuk holders and such trading of debt on a deferred basis is not permitted by Shariah. Mudarabah Sukuk is investment Sukuk that represent common ownership of units of equal value in the Mudarabah equity; the holders of Mudarabah Sukuk are the suppliers of capital and own shares in the Mudarabah equity and its returns according to the percentage of share ownership (Wilson, 2008). Mudarabah Sukuk should not contain a guarantee from the issuer or the manager of the fund, for the capital or a fixed profit, or a profit based on any percentage of the capital.

Musharakah Sukuk is investment Sukuk that represent ownership of Musharakah equity (MARC, 2006). It does not differ from the Mudarabah Sukuk except in the organization of the relationship between the party issuing such Sukuk and holders of these Sukuk, whereby the party issuing Sukuk forms a committee from the holders of the Sukuk, who can be referred to for investment decisions. Musharakah Sukuk is ideal for borrowing to finance large commercial ventures, such as a factory expansion or construction projects. Musharakah Sukuk can be treated as negotiable instruments and can be bought and sold in the secondary market. Ijarah Sukuk represents ownership of equal shares in a rented real estate or the usufruct of the real estate. Holders of Ijarah Sukuk have the right to own the real estate, receive the rent and trade their Sukuk in the secondary markets; in exchange they bear all cost of maintenance of and damage to the real estate. Unlike lease financing under conventional methods, the responsibility to maintain the underlying asset under the Ijarah facility rests on the financiers (Bakar, 2003). Upon default or maturity, the issuing entity issues a promise to purchase the assets at an agreed price.

Salam Sukuk refers to a sale in which payment is made in advance by the buyer, and the delivery of the asset is deferred by the seller (Wilson, 2008). It is more popular for short run financing Sukuk. The issuer of the certificates is the seller of the goods of Salam; the holders are the buyers of the goods; they are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any. The profit is the difference between the purchase price and the sale price. Istisna' Sukuk are certificates that carry equal value and are issued to mobilize funds required for production of goods and products that will be owned by the certificate holders. According to Engku (2008), the issuer of these certificates is the manufacturer; the subscribers are the buyers of the intended product, while the funds realized from subscription are the cost of the product. The Islamic bank is funding the manufacturer during the construction of the asset, acquires title to that asset and up on completion either immediately passes title to the developer on agreed deferred payment terms or, possibly, leases the asset to the developer under an Ijarah Sukuk. Shariah prohibits these certificates to be traded in the secondary market. Mudarabah and Musharakah are also known as equity financing in Islamic banking and to a certain extent they have some risks (Mohd Jaffar, 2010). As for other Shariah contracts like Murabahah (cost plus profit), Bai' Bithaman Ajil (sales through installments), Ijarah (rent and buy), Istisna' (manufacturing to order) and a few more that have less risks or no risk (Arif, 1989), these contracts are categorized as loan financing (BIMB, 1994).

In Malaysia, beginning in 1990s, the debt capital market has exhibited tremendous growth especially in the area of Islamic securities. The consistent growth of Sukuk issuance, increase in knowledge and expertise amongst market players, progressive development of the Malaysian regulatory framework and desire to seek a wider investor base especially from the Middle East, have prompted the promulgation of Sukuk issues based on the principles of Ijarah, Istisna', Musharakah and Mudarabah. In terms of global development, the overall Sukuk issuance volume also had increased to USD 179 billion at the end of Q2 2011 compared to 2010 (MIIFC, 2011). Kuwait Finance House (2012) reported that the global Sukuk market grew nearly 40 per cent year-by-year to the end of May 2012 with USD 55 billion issued as of the end of May 2012. Appetite among investors to launch Shariah compliant bonds to an increasingly receptive audience points to a bumper year ahead for Gulf's Sukuk issuer (Gavin, 2012). Standard & Poor's (2009) reported that the past decade witnessed the Islamic financial services sector growing at a rate of more than 10 per cent annually and has accumulating assets estimated to be worth USD 700 billion worldwide. Islamic finance is emerging as an alternative source of finance in addressing major development challenges faced by many Organization of Islamic Cooperation countries. The global market for Islamic financial services, as measured by the total volume of Shariah compliant assets, is estimated to have reached USD 1.1 trillion at the end of 2011. The Organization of Islamic Cooperation countries, with a collective share of 98% in these assets, continue to be the main actors in the industry's impressive growth story. Growth of global Islamic finance assets remained uninterrupted over the past decade. The overall size of the industry increased notably from only USD 80 billion at the beginning of the last decade to USD 1.1 trillion at the end of 2011.

3. Research Methodology

This paper conceptually discusses the construct of Sukuk with its rating and default risk implication. The ultimate objective of the study is to provide an understanding on the fundamental idea of Sukuk, its rating and its implication to default risk. Sources of data collection include observation, documents and texts, specifically from Securities Commission Malaysia (SC), Rating Agency Malaysia (RAM) and Malaysian Rating Corporation Berhad (MARC), Standard & Poor's report, and authors' analysis on the subject matter. Written data sources include published and unpublished documents, companies' reports, reports, newspapers articles and others. The financial information of Sukuk issuance and default over the period is obtained from the SC, RAM, MARC and Standard & Poor's report.

4. Sukuk Rating and Default Risk

Default on loan occurs when the borrower fails to make interest or principal payments when they are due. Default risk affects the interest rate charged on a debt instrument. The greater the default risk, the higher the interest rate charged by lenders. An increase in the riskiness of a borrower's operating cash flows will increase the likelihood of default (Kleiman, 2012). As financial market complexity and borrower diversity have grown over time, investors and regulators have increased their reliance on the opinions of the credit rating agencies. Credit ratings are in use in the financial markets of most developed economies as well in emerging market countries. Credit rating is a process of assessing the likelihood of timely payment of the principal and interest/profit over the duration of a particular debt. The rating is graded into two broad categories—investment grade and non-investment grade. The investment grade comprise ratings of AAA, AA, A and BBB, whilst the non- investment grade comprise ratings of BB, B, C and D. Bond or Sukuk ratings assigned by all the rating agencies are meant to indicate the likelihood of default or delayed payment of the security. To assist bond investors in making their assessment about the future payment prospects of a particular bond issue, ratings services such as Standard & Poor's and Moody's Investors Services assess the quality of various bonds by measuring default risk. Bond ratings have provided a good guide in gauging the risk of default. Default rates are very low for higher-rated bonds, and increase as the bond ratings decline. The higher the ratings are, the smaller the number of issues that would subsequently default. With lower ratings, the default percentage increases dramatically. Thus, the default premium widens as the ratings decrease.

As other conventional bonds, Sukuk may also promote default risk. Sukuk however are claiming to be safer than conventional bonds as they theoretically transfer ownership of the underlying assets to the holders, who in turn will earn a return on holding that asset (Othman and Kamarudzaman, 2012). This is regarded as protection for the Sukuk holders in case of default. Even if the issuer defaults or goes bankrupt, investors should be in a good position to recover much of their contributions. Therefore, providing asset security or corporate guarantees (referred as *Special Vehicle* in Sukuk contracts) to investors is vital in Sukuk structures. Sukuk also have to undergo credit rating similar to conventional bonds. Despite being a leader in Sukuk market, Malaysia has also recorded cases of Sukuk defaults such as Johor Corporation, Ingress Sukuk, Tracoma Holdings and Nam Fatt Berhad. Upon examining Sukuk default, Majid, Shahimi and Abdullah (2010) suggest that Sukuk default occurs due to the breach of any binding obligations under the original terms of the agreement between the issuer and the Sukuk holders.

Performance of the Sukuk issuer highly affects the final rating on the Sukuk itself. Rating on Sukuk reflects the creditworthiness of the issuer and stability of Sukuk. By having the annual rating reviews conducted by the respective rating agencies, Sukuk investors are adequately informed of the issuer's status and progress. In addition, negative rating migration (i.e. from A to B) on Sukuk may be significant to the possibility of Sukuk default to a certain extent. Generally, Sukuk with higher ratings are unlikely to default and vice versa. Bandyopadhyay (2006) posits that the credit quality worsens as the probability of default increases. In the wake of a series of high profile Sukuk defaults in the Gulf Corporation Countries, such as Investment Dar, Saad Group and Dubai World's Nakheel Sukuk in 2009, Sukuk are alleged to have lost credibility as feasible and viable Islamic long-term project financing instrument (Raja Abd Aziz, 2010). According to Securities Commission's annual report (2009), the default rate for Malaysian sukuk was relatively low at 0.46% in 2008. From 2002-2009, about 24 domestic sukuk had defaulted mainly (96%) in Bai' Bithaman Ajil and Murabahah structures.

5. Conclusion

Sukuk is vital and viable source of Islamic financing for the economic and social development. Sukuk compose of various types—depending on each instrument's purposes. Growth and acceptance of Sukuk are stable over the years and across the globe. However, the increasing number of defaulted Sukuk should be one of the concerns because it is closely related to credit risk. Sukuk issuance still needs to undergo a similar rating process like other bonds. Through this credit rating evaluation, in one hand, Sukuk may be seen as reliable credit instruments as other conventional debt. However, on the other hand, although Sukuk are issued together with asset security, Sukuk still faces the probability of default and thus the issuers' creditworthiness is essential. Future studies might focus on factors affecting Sukuk rating's migration and empirically examine the effect of Sukuk rating and its migration to firms' performance.

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