Do Sukuk Credit Ratings create a Value Effect?
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The Islamic finance industry has shown an extraordinary accomplishment in the last decade. A major contributor to this success can be attributed to a significant increase in sukuk issuance: from US$ 1.172 million in 2001 to US$ 138 billion in 2013. Malaysia is the world’s largest sukuk market with about US$ 430.579 billion of the total US$ 551.357 billion of domestic sukuk in the financial world, a whopping 78.09% of the total global domestic sukuk market. This significant development has necessitated the need for an effective credit rating mechanism for the Sukuk issuance. Credit rating has become an important instrument to assess the creditworthiness of an issuer, most often based on the history of the issuer’s borrowing and repayment, its underlying assets, its outstanding liabilities and its overall business performance (Arundina, Azmi Omar, & Kartiwi, 2015). Credit rating agencies play an important certification role in the capital market by verifying the credit worthiness of issuing firms, thereby facilitating investors’ investment decisions. The rating agencies usually conduct fundamental analysis to estimate the chances of default by the issuer in the near future, and a rating is assigned that reflects the probability of default. The rating is not a one-off affair but a continuous exercise to chart the possible drift in creditworthiness over the tenure of the bond/sukuk in fulfilling their obligation. For example, a rating of ‘AAA’ indicates that the creditworthiness is good and the chance of default is small. Conversely, a D rating indicates that a bond/sukuk issuer has extremely poor prospects with a higher probability of default. It is expected that investors will react adversely to announcements of downgrades in bond ratings. However, the issue of interest is how would the market react to Sukuk rating announcements? Not much has been documented on this specific issue, except for the negative market reaction to Sukuk announcements in Malaysia (Godlewski, Turk-ariss, & Weill, 2013). The probable rationale for this negative reaction is that the investors perceive the issuing firm as weak and issue Sukuk as a last resort due to its inability to issue conventional bonds.

Prior studies in the developed countries on issuance announcements of conventional bonds have indicated that financial information is a major determinant by the rating agencies in evaluating a firm’s ability to meet its future obligations. However, a firm’s financial information and reports could be subject to management’s creativity (i.e. Income smoothing) especially when they act opportunistically in their self-interest. Therefore, accounting variables alone are inadequate to explain a firm’s fundamentals and thus its creditworthiness. The worldwide corporation scandals e.g. Enron, WorldCom, Lehman Brothers and the Malaysian Transmile Group are examples of this creativity and its consequences. The implementation of effective corporate governance mechanisms that promote financial reporting transparency and effective monitoring on managerial decision could mitigate management opportunistic behaviors and provide reliable financial information, which ultimately lead to higher credit ratings (Bhojraj and Sengupta, 2003; Ashbaugh et al., 2006; Alali et al, 2012; Ling et al, 2013; Aman and Nguyen, 2013).

The issuing firm’s performance and creditworthiness and therefore default probability is also sensitive to macroeconomic factors such as the inflation and interest rates volatility. However, the literature also indicates that the macroeconomic factors have greater impact on sovereign Sukuk compared to corporate Sukuk rating (Ferri et al., 2001). They documented that since sovereign downgrading and firm downgrading are highly correlated in developing countries, it implies that factors of sovereign rating have a dual impact on corporate rating.

**Motivation**

The likeliness of default is the most important factor in the assessment of creditworthiness of issuers. In the Malaysian Sukuk market there are at least 36 cases of corporate Sukuk defaults by 33 issuers from 1990 to 2012, with the defaulted value estimated at RM 6.848 billion (Kamarudin et al., 2014). The defaults and potential defaults of Sukuk were not caused by the fact that they are Islamic financial products or because of faulty structures, but rather the deteriorating creditworthiness of the Sukuk issuing companies. Evidence on the factors that may affect the creditworthiness of the issuer could enhance the role of rating agencies in facilitating them to provide a more objective and realistic assessment which could mitigate default cases. Reducing the default cases will boost investor-confidence in the markets and enhance the reputation of the credit rating agency.”
To date, there is no published evidence of the determinants and sensitivity of sukuk credit rating in an emerging market like Malaysia, that hosts more than 80 percent of the Sukuk issued globally. This research highlights the firm financial characteristics, corporate governance attributes and macroeconomic factors, during the pre- and post-Shariah governance reform period (Shariah governance was reformed in 2011) as possible determinants of credit rating. The selection of the shariah governance reform period was to ascertain the effect of change in shariah governance regulations on the credibility of sukuk credit rating. These determinants affect rating change and therefore the value of the firm, as reflected in the firm’s stock price change.

Dataset and Sample
Information on rating of all corporate Sukuk issued in Malaysia during 2009 to 2014 were sourced from the Bond Pricing Agency Malaysia (BPA). The ratings range from AAA i.e. highest rating to D i.e. lowest rating. For the analysis, the multiple ratings were collapsed into seven categories, with category 1 being the worst and 7 being the best. The financial information and corporate governance attributes were collected from annual reports for listed companies and audited financial statements for unlisted companies. Information on the macroeconomic factors was collected from World Bank database. The information related to stock prices and indices were sourced from Datastream and Bursa Malaysia. The final sample includes 175 corporate issuers with 328 sukuk issuances and 1110 rating announcements.

Main Findings
The results indicate that both firm financial characteristics and corporate governance attributes have an effect on Sukuk credit rating. More specifically, firm size, return on assets, board size, independency and number of non-executive directors on the board have a significant positive effect on sukuk credit rating. Conversely, the CEO duality has a significant negative effect on sukuk credit rating. Neither ownership structure nor quality of financial reporting had any significant effect. In contrary to expectations, the macro-economic factors showed no effect on Sukuk rating announcements. Though not directly comparable, this evidence is inconsistent with literature on the bond market (Matthies, 2013; Rimpa & Arunkumar, 2014).

The findings suggest that the type of contract had an effect on the Sukuk credit rating, where the issuance of equity based Sukuk had a positive effect and debt based Sukuk, a negative effect. The negative effect of debt based Sukuk increased noticeably after the Shariah governance reform period. Finally, rating change had a significant impact on stock prices of Malaysian companies’ that issue bonds. This impact is significantly high for rating downgrades and less significant for upgrades. This is consistent with the behaviour of most investors that are more sensitive to losses than to gains.

Implications
It was observed that whilst most local rating agencies provide “A” class ratings for issuers, global rating agencies had lower rating grades for the same issuer. This discrepancy might be politically motivated and could affect investor’s trust (and thus their reputation) in Malaysian Sukuk rating agencies. It is possible that the emphasis on macroeconomic factors by foreign rating agencies could be the reason for the difference in rating, although this research showed no significant macroeconomic impact on sukuk credit rating.

Even though there were governance reforms in Malaysia, the findings indicate no significant impact of the reforms on credit rating. Probably more time is required for the reforms to take effect. Board independency has positive effects on credit rating, and this is possibly due to Bursa Malaysia’s requirements that at least 1/3 of the board must be independent. Other governance attributes are only recommendations of the best practices without specifying percentage or minimum requirements. The point is that the policy makers should develop a code of governance with clear specific requirements for issuing companies to comply with. However, rating agencies claimed that their rating is Shariah neutral and the Shariah governance framework should facilitate the various Sukuk structure preferences for some type of structures (debt or equity based) which might have implications on the Sukuk credit rating.

Issuers should take into consideration both financial and governance factors when they intend to issue Sukuk. In addition, they should be aware of the type of structure used as debt based sukuk are more likely to have a lower credit rating. Finally, investors must not only be aware of credit ratings when they intend investing in specific Sukuk, but also monitor the ratings for any unexpected changes (upgrade or downgrade) as this reflects the change in the quality of the issuer’s creditworthiness.

![Figure (1) The associated effect of independent variables on Sukuk credit Rating](image-url)