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Defaulters profile in Malaysia Sukuk market

Mohd Faizal Kamarudin, Norlela Kamaluddin, Siti Khadijah Ab. Manan, Gairuzazmi Mat Ghani*

Faculty of Business Management (FBM), UiTM 40450 Shah Alam, Selangor, Malaysia
Academy of Contemporary Islamic Studies (ACIS), UiTM 40450 Shah Alam, Selangor, Malaysia
Accounting Research Institute (ARI) and Academy of Contemporary Islamic Studies (ACIS), UiTM 40450 Shah Alam, Selangor, Malaysia
International Islamic University, Jalan Gombak 50728 Selayang Selangor, Malaysia

Abstract

The issue of sukuk default had gained particular attention in the recent years especially after the global financial crisis that hit the world economy. This study analyzes and profiling the sukuk defaulters in Malaysia. This study includes issuers of sukuk from 2000 to 2010. Information of the selected issuers of sukuk is extracted from their annual report in the CCM database. The study found that the highest number of sukuk default occurred in 2009. Mixed result was found on initial rating as default occurred for short-term and long-term instrument.

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1. Introduction

Sukuk is virtually unknown prior to 1990, but later has emerged as a viable financing option particularly in the 2000s. Although the value of sukuk is still below the conventional bonds value, it is gaining importance as reflected by 22.2 per cent cumulative average growth of the sukuk’s share in the total Malaysian Islamic capital market (MICM) in the period of 2000 to 2010. This average growth provides a clear evidence of the increasing popularity of sukuk among
corporate issuers and signifies the huge potential of this segment of the MICM as a viable financing option. Sukuk benefits borrowers and institutional investors in many aspects; for instance, it assists sovereign in managing fiscal imbalances. Subsequently, sukuk provides alternative funding for a firm thus enable them to deal with mismatched between liabilities and assets. Furthermore, it can also further enhance the stability of financial institutions by providing improved portfolio, liquidity, and risk management tools. Therefore, sukuk at least has equal ability or even better features to function alongside bonds in today sophisticated financial markets.

However, there is a misconception that sukuk is default-free compared to bond as it is based on Shariah principles. Just like many other financial instruments, sukuk also faces risks in the forms of default, call and market risks. Consequently, the sukuk market players such as the originator, servicer, issuer, special purpose entity and holders are exposed to various risks such as risk related to repurchase undertaking (binding promise), service default, default, bankruptcy, settlement and liquidity. Studies found that the default problem will lead to the financial distress followed by the extreme default of bankruptcy at a micro level (McKinsey, 1993; Dichev and Piotroski, 2001; Misnen and Abdul, 2010; Samsuddin, Tafri, Mohd Nawawi and Aziz, 2011). Furthermore, this phenomenon will lead to an economic crisis at a macro level (Altman, Brady, Andrea and Andrea, 2005).

The issue of sukuk default had gained particular attention in the recent years especially after the financial crisis that hit the world economy. Khinfer (2011) had described 2009 as the “default year” for the global sukuk market as the year ended with at least 15 cases, and rising to at least 31 defaults as officially reported globally in early 2012. The most concerning fact is that there were at least 36 cases of corporate sukuk defaults by 33 issuers from 1990 to 2012 with the defaulted value amounting RM 6.848 billion in Malaysia market. The defaults and potential defaults of sukuk was not caused by the fact that they are Islamic financial products, but driven by the market and credit risks (Vogel and Hayes, 1998; Tariq and Dar, 2007). In other words, sukuk defaults was not caused by faulty structures, but mainly due to the deteriorating credit positions of the issuers or companies’ failure. Furthermore, even though bond and sukuk have some similarities, there are some fundamental differences that exist between the two instruments which lie mainly in the very underlying nature or purpose of funding as well as the way they are structured.

So far, there has been no specific detail relating to sukuk default profiling. This paper would therefore look into the matter. Descriptive study is used to analyze the profile of sukuk defaulters in Malaysia. The samples cover both issuers of listed and non-listed companies. This study focuses on the profile of the defaulted sukuk and the issuers for the year 2009.

The paper is organized as follow; section two elaborates summary and theoretical of sukuk default. Next, we discuss the data and methodology in section three. Section four discusses the findings while the conclusion is summed up in section five.

2. Literature review

2.1 Theoretical framework of sukuk default risk

Since the study on sukuk default is new and it has few similarities with bond, this current study develop the theoretical framework of sukuk default primarily based on the fundamental principles of financing that are in accordance with Islam and supplemented by the theory of default risk of bond which derived from the economic theory of risk and return in finance and capital market.

Default risk is a risk that an issuer of a bond may be unable to make timely principal and interest payment. It also refers to credit risk, as gauged by commercial rating companies, which means the risk that a debtor will be unable to pay back its principal. On the other hand, default also includes the failure to perform on a futures contract as required by an exchange. It means defaulting on a futures contract occurs when one party does not fulfill the obligations set forth by the agreement. Each prospectus has provisions for the termination of the certificate in the event of a default by the obligor. The operational definition of sukuk default in this current study refers to the breach of any binding obligations under the original terms of the agreement between the issuer and holders of the sukuk including credit and counter party risk; coupon payment risk; principal amount reimbursement risk; asset redemption risk; and shariah risk. While according to RAM Rating Services Berhad and Malaysian Rating Corporation Berhad bond or sukuk default occurs; first, in the event of a missed or delayed disbursement of interest and/or principal, including delayed payments made within a grace period; second, an issuer files for bankruptcy or legal receivership occurs; or a distressed exchange
occurs where; (i) the issuer offers bondholders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount); or (ii) the exchange had the apparent purpose of helping the borrower avoid default.

2.2 Theory of default risk

Default risk is also referring to financial distress as well as bankruptcy prediction. Accordingly, the default risk of a financial asset is affected by the probability of default (PD), the loss given default (LGD), and the exposure at default (EAD) (Baykal, 2010). Default risk goes up if a debtor has large number of liabilities and poor cash flow. Hence, credit valuation framework should be based on the borrowers’ overall ability to pay or related to the credit worthiness of the borrower. In addition, it is important to have a theory that describes the relationship between the borrowers’ assets, capital structure and its potential default. Theoretically, default risk valuation should rest in debt pricing that corresponds to the risk taken. Hence, credit pricing and credit value at risk are the two important theories in assessing the default risk.

In general, there are four most commonly predictors of corporate default; first, financial ratios such as leverage, liquidity, profitability and efficiency (Beaver, 1966; Altman, 1968), market-based variables such as market value (Shumway, 2001), non-financial information such as corporate governance and firm’s characteristics (Bandyopadhyay, 2006) and the macroeconomic variables such as gross national product and inflation rate (Liou and Smith, 2006; Laurin and Martynenko, 2009).

Normally, the financial institutions and investors (the bond holders) value the risk of the firms (the bond issuers) by referring to the credit rating assigned by credit rating agencies. The credit rating gives the probability of the firm will default in its liabilities or how well the firm is expected to accomplish its liabilities. However, Hilscher and Wilson (2012) concluded that entities using the ratings default study are exposed to inaccurate analysis of firms’ credit risk because they are dominated by a simple model based on publicly available information at both short and long horizons and fail to capture relevant variation in default probabilities across firms. Hence, the ‘AA’ rating is not a guarantee that it will not default, only that, it is less likely to default than the ‘BBB’ firm. They further argued that recent models of default prediction are substantially more accurate than rating at predicting failure (Hilscher and Wilson, 2012).

2.3 Sukuk default profile

The defaults and potential defaults of sukuk was not caused by the fact that they are Islamic financial products, but driven by the market and credit risks (Tariq and Dar, 2007). In other words, a sukuk default was not caused by faulty structures, but mainly due to the credit-worthiness of the issuer. Hence, one of the most significant risks for sukuk investors to consider is credit risk. Credit risk, also known as default risk, is the risk that a sukuk issuer will default on their payments of profit, rental and principal. For the most part, sukuk issued by the sovereign are immune from default and therefore have low credit risk. However, sukuk that are issued by corporations are much more likely to be defaulted on, since companies subjected to economic cyclical. Hence, although there are many other risks to consider, understanding credit risk and its impact on the value of sukuk is a significant step that should be taken before investing. In other words, investors of corporate sukuk should have adequate knowledge on its credit risk and potential payoffs.

2.4 Initial rating

In the history of the development of debt market, credit rating agency has been thought as a key factor in minimizing investors concern on issuers default risks. Indeed, all ringgit sukuk denomination issued by corporate issuer in Malaysia must be rated. A considerable amount of literature has been published on credit rating (see, e.g., Altman and Saunders, 1997; Blume, Lim, and MacKinley, 1998; Cantor, 2004; Djankov, McLiesh, and Shleifer, 2007; Gande and Parsley, 2005; Hand, Holthausen, and Leftwich, 1992; Kisgen, 2006; Koopman, Lucas, and Monteiro, 2008; Sufi, 2009).

The generalization of much published research in regards to yield is that its rate follows the rating accord to an issuer. A worst rating would require the issuer to offer higher yield to the investor. It has been suggested that here is an unambiguous relationship between yield and rating (for a summary see Kliger and Sarig, 2000). It is widely used to
infer the resulting yield level. In essence, the higher the yield spread, the greater the investor accumulates return on top of the benchmark bonds. In regard to this, a large and growing research has focused on two areas. Firstly, the spread fluctuates over time and secondly, although one might suppose the contrary, it varies even among issuers within the same rating class (Lagner and Aufseb, 2012).

Apart from the initial yield, the credit rating agency will monitor the debt instruments and adjust the rating as required. Thus, several studies investigating the impact of rating transitions on bond and stock market reaction (see e.g. Abaffy, Bertocchi, Dupa cov´a, Moriggia, and Consigli, 2007). Up to the 1980s, evidence suggests that rating transitions would impact the pricing of bonds only to a negligible part (for a review see Liu and Seyyed, 1999). However, recent evidence suggests that that bond prices react negatively to rating downgrades, yet only insignificantly positively to rating upgrades (Liu and Seyyed, 1999). Likewise, rating downgrade impact the share price of an issuer on the stock market just as well (see, e.g., Abad-Romero and Robles-Fernandez, 2006; Barron, Clare, and Thomas, 1997; Hand et al., 1992; Holthausen and Leftwich, 1986; Jorion and Zhang, 2007; Norden and Weber, 2004).

2.5 Board size

Discussion on agency theory suggests that board size has positive influence on company’s performance hence lesser risk of default (Rodiel and Mc Reynald, 2012). Larger board could reduce shareholder-management conflict as potential moral hazard could be overseen. In addition, larger board could absorb uncertainties in business through larger sources of information. Nevertheless, other studies suggest that there is a significant negative relationship between board size and firm performance (Mak and Kusnadi, 2005). The study supports the earlier findings by Jensen (1993), Yermack (1996) and Eisenberg, Sundgren and Wells, (1998). Jensen argued that boards with 7 to 8 members are unlikely to be effective because larger boards often result in less coordination, communication and decision making while smaller boards size provide close monitoring over management leading to high performance hence lesser risk. A more recent study by Guest (2009) found strong negative effect of board size on profitability and therefore greater risk of default.

2.6 Financial ratios

Another way to assess the credit risk of sukuk is through the use of financial ratios. Some widely used metrics are liquidity and leverage ratios (Altman, 1968; Ohlson, 1980). Liquidity ratios are used to determine a company’s ability to meet its short-term debt obligations. In this article the proxy of liquidity ratios of the defaulted issuers is current ratio or current assets to current liabilities (CA/CL). General rule is that the higher the current ratio the better it is, but there is a limit to this. Acceptable current ratios vary from industry to industry and are generally between 1.5% and 3% for healthy businesses and it should not be used alone to evaluate a firm’s credit risk.

Leverage or solvency ratios indicate financial stability because they measure a company’s debt relative to its assets and equity. It measures the long-term financial viability of a business which means its ability to pay off its long-term obligations such as bank loans, bonds payable, etc. The debt ratio or total liabilities to total assets (TL/TA) are representing the leverage ratios. The ratio should be less than 1, and the lower the ratio, the lower is the default risk but, the acceptable levels will vary across industries and companies, and it should not be used alone to evaluate a firm’s credit risk.

Another parameter of probability of default is firm size. The firm size can be represented by total assets, total sales, total revenue, net profit, natural logarithm of total assets, etc. The proxy of the firm size in this analysis is total assets. Almost all prior empirical studies in accounting and finance have used total assets as the proxy of firm size (Osamah and Taisier, 2005). Theoretically, larger firms tend to be more diversified and more likely to obtain loans; hence, they are less prone to bankruptcy.

3. Data and methodology

This study includes issuers of sukuk from 2000 to 2010 excluding financial institutions, asset-backed securities and public finance companies. As a result, there are 286 sukuk issued by 214 companies amounting to nearly RM24 billion. Furthermore, based on the list and profile of defaulted sukuk published by RAM and MARC default study reports, it is
found that there are 29 defaulted issuers from 2000 to 2010. However, 2009 was chosen as base year for discussion. The year of 2009 was regard as the “default year” for the global sukuk market as the year ended with at least 15 cases (Khinfer, 2011).

Information of the selected issuers is extracted from their annual report in the CCM (Company Commission of Malaysia) database. Yearly data over 11 year period will be used and based on the reporting date. However, issuers without information for three consecutive years are excluded. Meanwhile, the ratios and size to be discussed are from the year of 2008 financial statements i.e one year before the occurrence of the event. However, if the 2008 yearly data is not available, data from the second year before the occurrence of the event is employed. This is following the studies on developing model for probability of default on the basis of one to five years before defaulted. As a result, there are only eight defaulted issuers with required parameters will be used to analyse the profile of sukuk defaulters via their financial information.

Descriptive study is used to analyze the profile of sukuk defaulters with much attention is given to overall profile of sukuk defaulter, industry, initial rating, board size and financial ratios.

4. Discussion

4.1 Overall sukuk default cases

Table 1 presents the corporate sukuk defaulted in Malaysia for a period of 5 years. In 2006, 3 corporate sukuk defaulted and increasing to 5 instances in 2007 and 2008. In 2009 the number of corporate defaulted sukuk rose markedly to 9 instances before dropping to 2 instances in 2010.

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of sukuk</td>
<td>3</td>
<td>5</td>
<td>5</td>
<td>9</td>
<td>2</td>
</tr>
</tbody>
</table>

Meanwhile, Table 2 displays the corporate sukuk default based on shariah contracts for 2006 – 2010. With regards to this, four shariah contracts were identified that are Ijarah, Bai Bithamin Ajil, Murabahah and hybrid structure of Bai Bithaman Ajil/Murabahah. During the period of study, sukuk with Murabahah structure recorded highest number of default of 10, followed by sukuk structure of Bai Bithaman Ajil with 9 sukuk default. In contrast, sukuk with Ijarah and Bai Bithaman Ajil/Murabahah structure witness 2 and 1 sukuk default respectively.

<table>
<thead>
<tr>
<th>Shariah Contracts</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ijarah</td>
<td>2</td>
</tr>
<tr>
<td>Bai Bithaman Ajil</td>
<td>9</td>
</tr>
<tr>
<td>Murabahah</td>
<td>10</td>
</tr>
<tr>
<td>Bai Bithaman Ajil/Murabahah</td>
<td>1</td>
</tr>
</tbody>
</table>

4.2 Industry sector

Table 3 depicts the corporate sukuk default based on economic sector in the year of 2009. In this case five economic sectors were identified, that are; property and real estate, trading and services, infrastructure and utilities, industrial products and transportation. Surprisingly, industrial products economic sector witnesses the highest number of
corporate sukuk default at four instances. This is followed by trading and services with two sukuk default instances. In contrast, property and real estate and transportation economic sector experience only once sukuk default.

<table>
<thead>
<tr>
<th>Economic Sectors</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property and real estate</td>
<td>1</td>
</tr>
<tr>
<td>Trading and Services</td>
<td>2</td>
</tr>
<tr>
<td>Infrastructure and utilities</td>
<td>1</td>
</tr>
<tr>
<td>Industrial products</td>
<td>4</td>
</tr>
<tr>
<td>Transportation</td>
<td>1</td>
</tr>
<tr>
<td>n.c</td>
<td>1</td>
</tr>
</tbody>
</table>

### 4.3 Sukuk initial rating

Table 4 depicts initial rating of defaulted sukuk under the period of study. Sukuk issued by Oxbridge Height Sdn. Bhd. was rated by RAM Rating Services Berhad. Subsequently, the remaining sukuk defaulted under period of study was rated by Malaysia Rating Agency Berhad. From this table we can see that the first five sukuk was rated with original maturities of one year or less (Malaysia Rating Corporation Berhad, 2012). The highest initial rating was given to sukuk issued by Oxbridge Height Sdn Bhd, while Oilcorp Berhad sukuk was given lowest initial rating. Meanwhile, the other five sukuk is instruments with maturities of more than one year (Malaysia Rating Corporation Berhad, 2012). Sukuk issued by PSSB Ship Management Sdn Bhd was given the highest rating while the lowest rating was assigned to sukuk issued by Tracoma Holdings Berhad and Englotechs Holding Bhd.

<table>
<thead>
<tr>
<th>No.</th>
<th>Date of Default</th>
<th>Date of Issuance</th>
<th>Initial Rating</th>
<th>Final Rating</th>
<th>Issuer</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>7/10/2009</td>
<td>7/10/2004</td>
<td>AA1D</td>
<td>D1D</td>
<td>Oilcorp Berhad</td>
</tr>
<tr>
<td>5</td>
<td>15/12/2009</td>
<td>15/12/2004</td>
<td>AAA1D</td>
<td>D1D</td>
<td>PSSB Ship Management Sdn Bhd</td>
</tr>
<tr>
<td>6</td>
<td>13/7/2009</td>
<td>9/7/2004</td>
<td>A+1D</td>
<td>D15</td>
<td>Ingress Sukuk Berhad</td>
</tr>
<tr>
<td>8</td>
<td>29/1/2009</td>
<td>28/1/2005</td>
<td>A1D</td>
<td>D1D</td>
<td>Tracoma Holdings Berhad</td>
</tr>
</tbody>
</table>

### 4.4 Board size

Data on the number of issuers’ board members as presented in Table 5 indicate that the majority are having smaller board size of less than seven. Contrary to Jensen (1993) and Guest (2009), higher percentage of issuers with smaller board size implied that larger board is favorable as far as default cases are concerned.
Table 5. Board size of sukuk issuers

<table>
<thead>
<tr>
<th>Board Size</th>
<th>Number of Cases</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 7 members</td>
<td>5</td>
<td>Smaller Size</td>
</tr>
<tr>
<td>&gt; 7 members</td>
<td>3</td>
<td>Larger Size</td>
</tr>
</tbody>
</table>

4.5 Financial ratios

The most widely used sukuk default measurements that can give us a glimpse of a company’s financial stability and credit worthiness are credit ratings and financial ratios of the corporations.

Table 6. Financial ratios and size of issuers before defaulter

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Industry</th>
<th>Fin Year</th>
<th>Liquidity</th>
<th>Leverage</th>
<th>Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tracoma Holdings Berhad</td>
<td>Industrial Product</td>
<td>2008</td>
<td>12.14189044</td>
<td>0.72777484</td>
<td>210,668,955</td>
</tr>
<tr>
<td>Engloitechs Holdings Berhad</td>
<td>Industrial Product</td>
<td>2008</td>
<td>0.193019074</td>
<td>0.462439094</td>
<td>111,050,397</td>
</tr>
<tr>
<td>Oxbridge Height Sdn Bhd</td>
<td>Property &amp; Real Estate</td>
<td>2006</td>
<td>1.088157542</td>
<td>0.947304563</td>
<td>279,720,157</td>
</tr>
<tr>
<td>M Trex Corporation Sdn Bhd</td>
<td>Industrial Product</td>
<td>2007</td>
<td>5.201903054</td>
<td>0.778431967</td>
<td>87,167,886</td>
</tr>
<tr>
<td>Ingress Sukuk Berhad</td>
<td>Industrial Product</td>
<td>2008</td>
<td>1.000000014</td>
<td>0.999999986</td>
<td>145,000,002</td>
</tr>
<tr>
<td>Oilcorp Berhad</td>
<td>Trading &amp; Services</td>
<td>2008</td>
<td>6.632168566</td>
<td>0.471057933</td>
<td>334,993,027</td>
</tr>
<tr>
<td>Maslaysia International Tuna</td>
<td>Infrastructures &amp; Utilities</td>
<td>2008</td>
<td>7.141545819</td>
<td>0.92406507</td>
<td>287,147,932</td>
</tr>
<tr>
<td>Straight A's Portfolio Sdn Bhd</td>
<td>Trading &amp; Services</td>
<td>2008</td>
<td>1.000000025</td>
<td>0.999999975</td>
<td>80,104,067</td>
</tr>
<tr>
<td>PSSB Ship Management Sdn Bhd</td>
<td>Transportation</td>
<td>2008</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td></td>
<td>max</td>
<td></td>
<td>12.14189044</td>
<td>0.999999986</td>
<td>334,993,027</td>
</tr>
<tr>
<td></td>
<td>min</td>
<td></td>
<td>0.193019074</td>
<td>0.462439094</td>
<td>80,104,067</td>
</tr>
<tr>
<td></td>
<td>average</td>
<td></td>
<td>4.299835567</td>
<td>0.788884179</td>
<td>191,981,553</td>
</tr>
</tbody>
</table>

From Table 6, 50% of the defaulters have current ratio less than 1.5 and 50% have current ratios higher than the desirable ratio of 3. If current liabilities exceed current assets (the current ratio is below 1), then the company may have problems meeting its short-term obligations (current liabilities). If the value of a current ratio is considered high, then the company may not be efficiently using its current assets, specifically cash, or its short-term financing options. A high current ratio can be a sign of problems in managing working capital (what is leftover of current assets after deducting current liabilities). While a low current ratio may indicate a problem in meeting current obligations. These two scenarios can be considered as the early warning of the issuers’ incapability for the next year. Eventually, they have defaulted in the next year (2009). This is consistent with the empirical findings by Altman (1968) and Ohlson (1980) that current ratio is one of the predictive determinants of default probability.

The range of the leverage ratio is between 0.99 and 0.46. Hence, all the issuers have the ratios of less than 1. Although the issuers’ debt ratios are in accordance with the general rule, they still defaulted in the following year. This can be explained as a low leverage ratio can also be interpreted that the company is growing slowly. Furthermore, having a high or low ratio does not necessarily mean it is bad or good. The acceptable levels will vary across industries.
and companies. In other words, the results obtained have different impact to different business entities. For example, real estate companies are usually highly leveraged, while companies in technological research are not. Moreover, this ratio should not be used alone to evaluate the creditworthiness of the issuer. For example, it can be analysed with the firm's interest coverage ratio whereby a high operating income will allow even a debt-burdened firm to meet its obligations. Empirically, Altman (1968) and Ohlson (1980) suggested that the debt ratio is significant to predict the probability of default.

The minimum size of the firms is RM 80.1 million and the maximum is RM 334.99. About 50% of the issuers have a range of total asset from RM 210.67 million to RM 334.99 million. Accordingly, the larger firms are less prone to bankruptcy. However, these issuers have defaulted. Altman (1968) and Asmawi and Shahadan (2013) argued that size is negatively related to default. On the contrary, Ohlson (1980) claimed that size is positively related to default.

5. Conclusion

Sukuk gives an alternative funding for issuer. This is in consonance with the huge demand from Middle East that has high liquidity. Although, the total sukuk outstanding is relative small as compared to the global capital market there is significant demand for it. It is demonstrated by increasing issuance of sukuk by sovereign and corporate firms. More often than not, this issuance is over-subscribed by multiple times. However, it is self-fallacy to assume that sukuk is debt-free compared to bond as it is based on Shariah principles. The defaults and potential defaults of sukuk was not caused by the fact that they are Islamic financial products, but driven by the market and credit risks (Tariq and Dar, 2007). In other words, a sukuk default was not caused by faulty structures, but mainly due to the credit-worthiness of the issuer.

This study has given an account on the sukuk defaults profile in Malaysia. It is found that the highest no of sukuk default occurred in 2009. This is consistent with global trend which has seen 15 sukuk defaulted in that particular year (Khinfer, 2011). In addition, most default was recorded in industrial products sector. However, we find mixed result on initial rating as default occurred for short-term and long-term instrument with PSSB Ship Management Sdn Bhd, assigned AA rating, and also defaulted after five years of issuance. The findings also show that there is positive relationship between board size and sukuk default instances. In regards to financial ratios the sukuk defaulters are in plague with twin problem of current ratio that eventually leads to its default.

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