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Credit Risk Management for *Sukuk*: A Case Study of Debt-Based *Sukuk*

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ABSTRACT

Sukuk default is an increasingly worrying phenomenon because it might reduce investors' confidence in this Islamic type of investment. Being the hub for the Islamic finance, Malaysia as the world's largest *sukuk* issuer might not escaped to this issue as well. Currently in Malaysia, there are more than 24 cases have been recorded in relation to the corporate *sukuk* default and the major contributor to this problem is due to poor management of credit risk. How should credit risk be managed for *sukuk*? Is it the same as the credit risk management for conventional bonds? Focusing on debt-based *sukuk*, i.e. *ijarah sukuk*, the objective of this paper is to study on how credit risk can be managed in the *sukuk* framework in order to strengthen the structure and to prevent it from default. Hence, the significance of this study is to help giving some idea on how to improve credit risk management in *sukuk* and it might be useful for further research. This study will also look at one example of default case which is *ijarah sukuk* by Ingress Corporation Bhd. Throughout the paper, findings show that credit risk management application used for debt-based *sukuk* is about the same as in the conventional bonds. The difference only happens in the methodology used to rate at the rating stage by the rating agency for these two instruments. At the end of this paper, the issuers of *sukuk* are suggested to strengthen their existing indicators in credit risk management for *sukuk* and try to explore other alternative indicators which are *syariah* compliant to secure their *sukuk* financing so that defaults might not happen in the future.

Keywords: Credit Risks Management, Debt-Based *Sukuk*, Ingress Corporation Bhd, *Sukuk* Default

INTRODUCTION

According to the Standard & Poor (S&P) report, Malaysian Ringgit is now towards becoming the choice of currency for *sukuk* issuance. This is proven by the raise in ringgit *sukuk* market by the Gulf Cooperation Council borrowers which comprises Bahrain, Kuwait, Saudi Arabia, Oman, the United Arab Emirates and Qatar from $571 million last year, up from $323 million in 2010. In addition to that, the amount issued in ringgit worldwide exceeded the amount issued by Malaysian issuers in all currencies for the first time (S&P, 2013).

Despite of having promising demands for *sukuk*, Malaysia also is in the lead in the case of *sukuk* default. As of now, there are more than 24 default cases happened in Malaysia since last 15 years. Hafizi et al. (2010) and Nursilah et al. (2012), found that at least in Malaysian case, these long-term debt-based *sukuk* are seen to have a more tendency to default rather than the profit-sharing based of *sukuk* which can be explained by several cases like *ijarah sukuk* by Ingress *Sukuk* Bhd and *murabahah sukuk* by Nam Fatt Corporation Bhd and Johor Corporation (JCorp).

The reason behind the defaulted cases that happen is driven by credit market and credit risks (Remo-Listana, 2010). Therefore, a question arise on how should credit risk be managed for *sukuk*? Is it the same as the credit risk management that is applied for conventional bonds? Since Conventional Bond is an interest-based instrument that is using a loan concept, therefore the best comparison can be made to the *sukuk* is by using the same debt-based instrument instead of profit-sharing-based *sukuk* which is not available in the conventional regime. Thus, the objective of this paper is to find the appropriate answer by focusing on the debt-based *sukuk* such as *ijarah sukuk* and to study on how credit risk can be managed in the *sukuk* framework in order to strengthen the structure and to prevent it from default. The significance of the paper is to help giving some idea on how can credit risk management in *sukuk* be improved and it might be useful for further research.

The paper is organized as follows; following this introduction section, section 2 will be discussing on the related literature on the background of *sukuk* generally. Section 3 outlines the research method and section 4 is on the case study analysis while in section 5 is a discussion from the case study analysis done. Finally, in section 6 will be the conclusion of the paper.

LITERATURE REVIEW

Sukuk Concept

Sukuk is a plural word of *sakk* in Arabic which refers to financial papers or certificates. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) define *sukuk* as:

> 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, however, this is true after the receipt of the value of the *sukuk*, the closing of the subscription and employment of funds received for the purpose for which the *sukuk* were issued.[1]

The Malaysian Securities Commision however has its own definition with regards to *sukuk* which refers to:

> Certificates of equal value which evidence undivided ownership or investment in the assets using *Syariah* principles and concepts endorsed by the *Syariah* Advisory Council (SAC), but shall not include any agreement for a financing/investment where the financier/investor and customer/investee are signatories to the agreement and where the financing/investment of money is in the ordinary course of business of the financier/investor, and any promissory note issued under the terms of such an agreement.

Here, we can see that The Malaysian Securities Commission in its "Guidelines on *Sukuk*" which was revised and effective on 28th December 2012 has a more precise meaning in defining *sukuk* compared to AAOIFI's way of interpreting *sukuk*. The reason is probably due to meet the Malaysian market demand.

Sukuk was initially introduced as Islamic alternative to bonds that have a similar function which is fixed-income instruments but as time passed, and as *sukuk* structures have developed, this concept is seen to be totally erroneous. *Sukuk* is not meant to mimic the conventional interest-based securities that portray a contractual debt obligation but rather an Islamic finance's innovation types of assets management that are *syariah* compliant.

Malaysian *Sukuk* Market

When Malaysia decided to become pioneer in *sukuk* about 18 years ago, it is now turn out to be a very wise decision when looking at where we are now. Malaysia is currently the leader and becoming the global Islamic finance center. Although the Middle-Eastern countries are rich and more than capable in issuing and investing in *sukuk*, Malaysia constitutes to be the favorable and destination for *sukuk* issuers globally because of the availability and ample liquidity with established infrastructure for the *sukuk* market benefited from the global liquidity pool that moving away from risky markets to the safer markets due to the growth of global *sukuk* fuelled by mega projects in the Middle East and Asia (Zairulnizad, 2012).

RAM *Sukuk* Focus in its report states that:

> Malaysia continued to dominate the global *sukuk* market with issues mainly to fund infrastructure development. Besides the PLUS issuance, regular issues were made by the Malaysian government and central bank, amounting to a total of USD63 billion. Overall, Malaysia issued USD97.1 billion of *sukuk* last year, accounting for 69.7% of the total (refer to Chart 1). As with the global scene, Malaysian *sukuk* issuances have hit a record high. The market continues to be boosted by encouraging demands for ringgit-denominated *sukuk* and a comprehensive regulatory framework.

[1] AAOIFI's Shari'a Board Resolutions on *Sukuk*

There is a case study written by Ali Said (2011) that tried to see on the impacts of the use of *sukuk* to the Islamic banks's performance. The author used a sample of 14 Islamic Banks all over the world that applied *sukuk* as one of their instruments in the range year of 2007-2009. Through the uses of regression analysis, he learned that *sukuk* has no impact on the performance of the Islamic banks. The study also showed that by the use of *sukuk*, Islamic Banks were able to provide liquidity and mobility for bank resources. Therefore, currently it is like a trend that there are lots of Islamic institutions particularly Islamic banks applied or invest in *sukuk* as one of their way of raising capital and diversification for example AmBank Investment, Maybank, Affin Islamic, Kuwait Finance House and etc.

***Sukuk* Default**

Recent study on *sukuk* is more towards the implication and risks of *sukuk* as the trend of *sukuk* default can be seen arising from time to time. The first *sukuk* to default that shocked the financial world was experienced by Dubai World's developer, Nakheel which was especially known for the construction of the Dubai Palm Islands in 2009. Omar (2010) did a case study research on what happen in Nakheel *sukuk* that brought them to restructure the *sukuk* and nearly face bankruptcy but finally saved by Abu Dhabi which is also an emirate of the UAE that granted Dubai a $10 billion loan to repay some of its debts

Zhamal (2010) in his writing mentioned that the risk of default is higher for *sukuk* compared with conventional bonds with the fact that *syariah* prohibits debt trading and thus make any rescheduling of debt for higher markup is forbidden under *sukuk* as well. He added that *sukuk* is a certificate of ownership, consequently, *sukuk* holders have a very limited opportunity to retrieve their initial investment in the case of default as compared to conventional bond that hold a debt obligation which is seen to be easy and more liquid. Therefore, he suggests that by the creation of appropriate legislative basis, any possible default can be measured and solved.

Haider, J., & Azhar, M. (2011) bring a deep discussion on the matter of risk management in *sukuk*. The authors make a few recommendations so that defaults can be avoided in the future. One of it is *syariah* special credit rating, risk management consultancy firms and education and training institutions should be established in order to generate expertise in Islamic economics, finance and in *sukuk*. Aini N. and Rafisah (2011) discussed on the issues regarding *sukuk* default where they conclude that the defaults that occurred in the Middle-East countries which hold a high profile *sukuk* is a result of the economic difficulties and nothing to do with the validity of *sukuk* methodology.

***Sukuk* and Credit Risk Management**

Hafizi et al. (2010), see that there is a necessity for an analysis to be made on credit risk and rating performance toward the *sukuk* default itself. Several *sukuk* default cases that occurred in Malaysia were analyzed such as Nam Fatt Corporation Bhd, Tracoma Holdings Bhd and Ingress *Sukuk* Bhd. Although these default cases might not give a significant threat to the Malaysia Capital Market specifically, but it might somehow bring a negative impact to the Malaysian reputation as a hub for global Islamic finance generally. Nor Balkish et al., (2012), also further discussed conceptually on the *sukuk* structure, ratings and default risk. They reached that the increasing number of defaulted *sukuk* should be one of the concerns because it is closely related to credit risk and through credit rating evaluation, in one hand, *sukuk* may be seen as reliable credit instruments as other conventional debt.

Nursilah and Norailis (2012) further agreed with the opinion that the defaults that occur are the result of the economic downturns. The authors then tried to estimate the distant-to-default (DTD) as a risk indicator for *sukuk* in Malaysia using KMV-Merton model and reached that bigger size of *sukuk* issuance is having a relatively less risky. In addition to that, the sample of study used by the author also shows that the most financing contracts that tend to default are the debt-based type of *sukuk* such as *ijarah*, *BBA* and *murabahah*. This thus support and strengthen the significant of this paper which is to see how can risk especially credit risk be managed and strengthened especially in debt-based *sukuk* that keen to default.

RESEARCH METHOD

Method used in this paper is qualitative and explanatory research case study where data are collected within the scope of *sukuk* default and focusing on the case study of credit default on debt-based *sukuk* which is *ijarah sukuk*. Qualitative method is used because of the limited time and data that can be pooled within this scope of study which is credit risk management for *sukuk*. In addition to that, an explanatory method is used among other qualitative approaches in conducting a research is due to its nature that gives researcher to reason her mind regarding the case study conducted. To give a more meaning to this research paper, a case study is chosen because the researcher wants to prove her hypothesis and to analyze the real default case that happened in *sukuk* so that she can find the reasons behind.

The objective of this study is to observe the significant of credit management in *sukuk* structure. Therefore, throughout the analysis, the paper will try to investigate on the application of *ijarah sukuk* by Ingress Corporation Bhd as the case study sample and find the cause of the default happened that somehow might lead us back to its credit risk management. Apart from having a face to face interview with the Ingress Corporation's personnel, resources are collected from written data sources include published (i.e. archival research) from Security Commission Malaysia, Rating Agency Malaysia (RAM), Malaysian Rating Corporation Berhad (MARC) and unpublished documents, reports, newspaper articles and company website as well as some references from the previous literature and author's analysis on the subject matter.

ANALYSIS

There are two main categories of *sukuk* namely debt-based *sukuk* and equity-based *sukuk*. The debt-based *sukuk* as defined by IFSB (2005) is a "*sukuk* where the underlying assets offer fairly predictable returns to the *sukuk* holders, such as in the case of s*alam*, *istisna* and *ijarah*". Meanwhile the equity-based *sukuk* is defined as "*sukuk* where the returns are determined on profit and loss sharing in the underlying investment, which does not offer fairly predictable returns such in case of *musharakah* or *mudharabah* for trading purposes". Among these contracts, evidence proved by the Rating Agency Malaysia Bhd (RAM) showing that the debt-based *sukuk* such as *ijarah*, *BBA* and *murabahah* is to be the most favorable financing contracts among the issuers of the corporate *sukuk* market in Malaysia (see chart 2) and as discussed in earlier section, we knew that this type of *sukuk* also contributed to the most cases of default in Malaysia.

Credit Risk Management

Credit risk is the probability that the issuer of the *sukuk* is unable to fulfill the contractual obligation or the asset pooled becomes irrecoverable due to a default or delay in settlements whether in the profit due or the principal amount. Different from conventional bond, *sukuk* have certain *syariah* concerns that need consideration apart from the credit matters in relation to the event of default. Nevertheless, this *syariah* issues is not the main contributor to the *sukuk* default problem. Credit management does. Rafisah and Aini N. (2013) inferred from Remo-Listana (2010) states that "mostly, *sukuk* defaults are the result of market and credit risk rather than structural problems or *syariah* compliancy shortfalls. In fact, all defaults and potential defaults have been driven by credit market and credit risks". Therefore, we might say that credit default is solely born by the credit risk management of the *sukuk* itself.

Allah mentioned in *Al-Quran* about risk in *Surah Al-A'raf ayah* 34 which means "And for every nation is a [specified] term. So when their time has come, they will not remain behind an hour, nor will they precede [it]." This ayah clearly shows and reminds us on the existence of risks by resembling it to the death of the mankind. Not only that, there is a *hadith* from Prophet Muhammad which was narrated by Ibn Majah regarding risk: " الخراج بالضمان " which means profit or return is the price for the risks that one should bear. From these *dalil*, Islamic Institutions was led and guided to manage their risks well. It is understood that risks are inevitable therefore; it should be borne by the parties involved in any *muamalat* contract as this is part of *syariah* requirement and *fitrah* (nature) of the Islamic contract itself.

When any projects to be done require financing tool whether it is through bond or *sukuk*, credit risk or credit default is something that should be expected to happen either by the issuer or the investors. It might not be escaped but it can be reduced. It depends on which tool we choose to finance the project. In *sukuk*, the contract used in dealing between the issuer and the investors is a sale contract where there is a need for tangible assets to be traded compared to bonds where a simple receivable can be sold to the investors. Thus, the sale of *sukuk* represents a sale of share of an asset whereas in bonds, it is merely a sale of debt. As the investors hold the share on the asset, from investors' point of view, with the nature of *sukuk* which is asset-backed, it is a kind of guarantee in the case of default. It can be referred as a 'build in safety' for the investors. In addition to that, *sukuk* prices and returned are market driven which lies on supply and demand on the asset compared to bonds which return are relying on the creditworthiness of the issuer. Therefore, if default happens, the issuer of *sukuk* may liquidate the asset first and dissolve the *sukuk* project before come in to the company's asset whereas in bonds, the investors may seek for the company's asset directly for dissolution. At least, *sukuk* issuers have a better choice of credit risk management in the case of default.

Haider, J., & Azhar, M. (2011) quoted from Kokab (2010) however states that "When you look at the *sukuk* to know the credit risk it seems to be very confusing" because *sukuk* structure is more complex than the conventional bond. Asset-backed *sukuk* may have different approach towards managing credit risk as compared to the asset-based *sukuk* which has similar nature of credit risk to the conventional bond. Therefore, the credit risk management framework for *sukuk* is in no different with what has been applied in the conventional bond. Starting from the identification of the risk, measurement, assessment, monitoring and control of the risk was all about the same. Fahima N. (2011) in the opinion that the biggest challenge in managing credit risk for Islamic institutions is to form a balance so that the profits made commensurate with the risks incurred. Anyhow, looking at the advantages that *sukuk* possess compared to the conventional bonds, only through better management of the assets with skills and expertise by the credit risk team of the institution, this risk will be well managed. This is where we are still lacking now.

There is worth noting that other than aspects that have been discussed above, the matter that makes these two instruments (conventional bond and *sukuk*) distinguish is at the rating stage by the rating agencies. There are special judgments and significant methodologies used by the rating agency in rating any particular *sukuk* to be issued. MARC outlined these analytical components in rating *sukuk* transaction :[2]

> 1. Analysis of the basic structure of the *sukuk* – MARC's evaluation of a s*ukuk* structure revolves around its structuring intent, i.e. whether an issue is structured as an asset-backed transaction (in which case it would reflect the performance of the securitized assets) or to achieve a flow-through of the rating of the originator or third-party obligor(s) or guarantor to the *sukuk*. The structure of the s*ukuk* will have significant impact on the risk profile of the *sukuk* and determines the rating methodology to be used (conventional corporate and project finance rating methodology or asset-backed methodology).
>
> 2. Assessment of key transaction parties - MARC considers the roles of key participants in the transaction: originator, lessee(s) or obligor(s), guarantor(s), contractor, servicer/back-up servicer as well as the credit quality of each participant and ability to perform their roles, and the corresponding implications of such for the risk profile of the s*ukuk*. A shadow rating may be performed on key participants where MARC believes their credit quality is an important driver of the rating of the *sukuk* issued.
>
> 3. Asset and cash flow analysis – This analysis is the most important driver of the ratings assigned to 'asset-backed' and non-recourse or limited recourse project finance s*ukuk*. Some s*ukuk* are structured with external liquidity support and/or reserve accounts to mitigate interim deficiencies in returns from the assets. Alternatively, the deficiency may be a direct and irrevocable obligation of the originator as Manager of the s*ukuk*, as in existing 'asset-based' s*ukuk* transactions. The valuation of the asset(s) forms an important part of MARC's review where redemption of s*ukuk* is to be partially or wholly derived from refinancing or disposal of the asset(s) to third parties.
>
> 4. Assessment of credit enhancement and structural protections – MARC assesses the internal credit enhancements such as reserve accounts, payment waterfalls and collateral value in addition to external credit support which may be provided by the originator/obligor or third party guarantor(s).
>
> 5. Legal analysis – The perfection of legal interest in the underlying assets and the insulation of the assets from insolvency or reorganization of the originator/seller are important not only in the context of any securitization but also from the perspective of any secured financing. The terms under which the *sukuk* are issued may specify certain 'trigger' events that, if they occur, would cause the transaction to be wound down. These could include failure of the lessee to make required lease payments under as s*ukuk al-ijarah* structure, and certain events of insolvency and default connected with the lessee. In *sukuk* structures involving a SPV issuer,

[2] MARC. 2012. Rating Approach To *Sukuk*: A Marc Perspective.

MARC will consider the bankruptcy remoteness of the SPV and the limitations on the business activities of the SPV.

Concisely, credit risk management for *sukuk* should not be worried at the initial rating stage but after it is rated. The real challenge begins at how to maintain the rating so that it will not be downgraded at the next rating requirement. Here is where the credit risk management team of the institution plays a vital role. Skill, knowledge and experience are very important and this is where we are still lacking even though we are the center and source of information on the subject of *sukuk*. The best example can be seen in the *ijarah sukuk* by Ingress Corporation Bhd which will be discussed next.

The Case Study of *Ijarah Sukuk* by Ingress Corporation Bhd

Company Background

Ingress Corporation Berhad (ICB) was incorporated in May 1991 with the main activity is manufacturing automotive components to supply the increasing number of car makers who were at blooming in the early 90s domestically and globally. This growing market demand thus lead the company to grow even wider from producing simple and single parts of the automotive components to a complete range and more sophisticated form of the car components. In April 2001, ICB was very proud to be listed publicly on the Main Market of Bursa Malaysia showing the substantiality and tenacity of the company. Nowadays, ICB not only involve in manufacturing the automotive components but also providing expertise and experience in power engineering and railway sector to meet the Malaysian market demand. Ingress also enjoys a reputable presence in Thailand, Indonesia and India and proud to be known as one of the region's leading automotive component manufacturers.[3] In addition to that, ICB with the existing skills they have is currently looking forward to engage in the oil & gas sector as this industry (i.e. especially Malaysia) is showing a promising future.

Back to the early 2000s where ICB was in its triumph, with the award from Honda and Nissan, ICB was very eager to expand their business further to Thailand with the support from the Katayama Kogyo, the largest Japan auto part maker. ICB wishes to penetrate the global automotive market through Thailand operation. In addition to that, the ASEAN Free Trade Area (AFTA) which was expected to be implemented in 2003 has opened the door for liberalization of the automotive industry and gives another booster to the company to fulfill its mission. To be added to the successful story of the company, Ingress was captured by the UMW, the leading automotive industry in the world and was offered to supply components and parts for them to be included in over 20 000 vehicle sets per year. All these unexpected demands require capital which the company might shortfall of. Thus, ingress decided to issue *sukuk* in order to get fund for the expansion purposes. At the time, *ijarah sukuk* was the best choice and on its increasing demand within the capital market itself (“Ingress Corporation”, 2007).

Ingress Ijarah Sukuk Structure

Malaysian Security Commision (2012) highlights that *ijarah sukuk* is “certificates of equal value evidencing the certificate holder’s undivided ownership of the leased asset and/or usufruct and/or services and rights to the rental receivables from the said leased asset and/or usufruct and/or services.” The ICB choose this *sukuk* structure for its cash flow flexibility. And for this purpose, Ingress Sukuk Berhad (ISB) was incorporated to act as a Special Purpose Vehicle (SPV) to govern the whole operation related to the *ijarah sukuk* issuance. The *sukuk* was issued with 7 years of maturity commencing in July 2004 and expected to mature at July 2011. Generally, there are 9 companies that are listed as the *sukuk* holders for this *sukuk* issuance which are CIMB, MAYBANK, Petronas, RHB, ING, MAA, KWAP, AFFIN, and HSBC. The *ijarah sukuk* structure applied by ICB can be explained by Figure 1.

Default

At first, looking at the promising demands that Ingress Corporation Berhad experiencing plus the establish credit and cash flow of the company, ICB was rated as an $A+_{IS}$ by the MARC. Nevertheless, in Dec 2007, the rating started to be downgraded by the MARC to A_{IS} and this rating keep decreasing till it was rated to D_{IS} in July 2009 that brought to the cancellation of the *sukuk* program in 2010 (Hafizi

[3] http://www.ingresscorp.com.my

et al, 2010). The rating timeline of the Ingress *Sukuk* can be seen in Figure 2. The decision to downgrade the rating to D_{IS} in 2009 by MARC was due to the failure of Ingress Sukuk Bhd to meet the first tranche of the payment amounting to RM 50 million that was supposed to be distributed on July 2009 to the *sukuk* holders.

There are two main reasons given by the ICB in explaining the situation happened. First is due to their credit management and second is because of the economic financial crisis. “Ingress Corporation” (2007) explains that the former happened because the company has an inadequate time and unable to resolve the issue of *ijarah sukuk’s* covenant that restrict the debt to equity ratio which must not exceed 1.75 times and the aggregate of existing securities must not exceed 20% of the NTA - Net Tangible Assets which the company had violated through the outside debt made to support the operations in Thailand. What did the company do after realized that they had violated the covenant then? How do they try to solve this credit management problem? ICB did sought for shareholders consent to waive such covenant so that restructuring process of the *sukuk* structure can be made but was not successful. This thus led to the failure of fulfilling the payment of the first tranche.

The later reason is explained by the sub-prime mortgage that happened in US which shaken the world’s economic financial system. This so called ‘US housing bubble’ phenomenon reflected prices for goods in general thus affected the overall interest rate in the market. Therefore, any financial activities that involve the use of interest rate might hardly be affected. During this financial crisis, Islamic financial institutions however were shielded and do not suffer much from this credit crunch. (Abdelaziz & Lateef, 2010). Nevertheless, as Islamic financial institutions work within the conventional regime, the whole operation of Islamic institutions might not escaped but influenced as well. This was what happened with the Ingress *sukuk*. As the demand for automobile plummeted, the company’s revenue also decreased and made it even harder for the company to pay their first tranche.

Based on this default case, what can be inferred is that first, there is a lack in the credit management of the company. Since this is the ICB’s first trial to the *sukuk* framework, more attention on credit risk management supposed to always be in focus and discussion from time to time especially at the high management level. The company might feel that they were in a comfort zone as demand was always encouraging then they were not put so much attention to any possible problem that may occur. Besides, if credit risk management is always in the loop, other opportunity or alternative to fund the job in Thailand might be sought out and adding further debts to top up the operation fund might not happened. Other than that, diversification is also important to help improving the credit management of the *sukuk*. What is meant by this is that Ingress might also plan or have another *sukuk* framework so that risks can be diversified within the *sukuk* portfolio. But again, as this is the company’s first attempt in approaching *sukuk*, therefore, there might be absence of proper knowledge and skill with regard to this.

DISCUSSION

Indicators used to strengthen the credit risk management in *sukuk*:

Portfolio diversification

According to Kealhofer, S., and Bohn, J. R. (1998), “default risk can be reduced and managed through diversification. Default risk, and the rewards for bearing it, will ultimately be owned by those who can diversify it best”. Zhamal (2010) also come out that diversification is another problem for *sukuk* market due to most of the issues are concentrated in the real estate sector and only in two main geographical locations, i.e. GCC and Malaysia. Managing *sukuk* portfolio requires knowledge and a special know-how in both *syariah* and *muamalat*. As it is still at its adolescence age, the world still lack of expertise in this area thus exposes the *sukuk* framework to higher credit risk.

As *sukuk* is now at blooming, many conventional institutions are prying into this instrument as one of their way of raising capital or diversification. *Sukuk* is a *syariah* compliance instrument; therefore its portfolio diversification should also meet *syariah* obligation. It is important to see other opportunity or improvement for diversification in *sukuk* framework. Zhamal (2010) suggests that some measures can help in improving *sukuk* market efficiency and reduce its risks and one of them is by exploring diversification of *sukuk* issues in terms of their maturities, geographical locations and sectors of industry.

A suggestion can be made here and for example to say, if a company wishes to issue *sukuk* to finance certain project, it is important to ensure that they already have other existing *sukuk* portfolio which can be act as a guarantor to the new *sukuk* to come. This is prevention in the case of default. Let say, if the company is to issue *sukuk* for the first time like what happened with Ingress corporation, a suggestion can be made that they may need to issue two *sukuk* structures that may pool two different assets from different or better substitute sector to each other (i.e. automotive and consumer products) using the same source of fund (the shareholders) at the same time. It may be possible to be done. However, it is not an easy job since it may requires a lot of discussion, works, money and also expertise.

Third party guarantee (Kafalah)

Al-Bashir. M. (2011) found that the issue of guarantee generally arises as the *sukuk* issuer benefiting from the *sukuk* proceed establishes a Special Purpose Vehicle (SPV) that will issue the *sukuk* while the *sukuk* issuer just now will only stand by it and act as a third party guarantee against any shortfall. The concept of the third party guarantee is a mechanism used to protect investors in *sukuk* and it deemed to be permissible in *syariah*. The problem with this is that, normally, the third party guarantee is the originator itself. Therefore, when default occurs and if the originator company cannot afford to make full payment, shareholders will suffer losses. It is better if the issuer or the originator company who wishes to issue *sukuk* point another third party guarantee or associated company apart from the company itself so that shareholders' interest can be protected.

The Malaysian Securities Commission in its Guideline for *sukuk* also outlined that *Kafalah* may be provided under *sukuk* either by the third party or *wakeel*/sub-*wakeel* appointed by the issuer or related party or associated company of the issuer. And in the case of default, the guarantor shall be liable on the principal or the profit due to the investors.

Asset security or Collateral (Rahn)

The Malaysian Securities Commission refers the asset security or collateral as "an act whereby a valuable asset is made as collateral for a debt. The collateral will be utilized to settle the debt when a debtor is in default." Different from conventional bonds, *sukuk* framework has an asset backed to the structure which acts as a protection and collateral to the investors in the case of default. *Sukuk* are theoretically transfer ownership of the underlying assets to the *sukuk* holders, who in turn earn returns on holding that asset, therefore, they are seemingly be safer and secure than the conventional bonds.

عن أبي هريرة أن رسول الله صلى الله عليه وسلم قال: لا يغلق الرهن من صاحبه الذى رهنه له غنمه وعليه غرمه

> *"From Abu Hurairah that Rasulullah SAW have said: A charged asset will not diminish from its owner (when he has not yet settled his debt). Any profit of the charged asset belongs to its owner and any liability must be borne by him."*

Because *sukuk* are backed with tangible, identifiable underlying assets, they are thus exposed to some risks. One of the risks is when returns to the investors are depending on the performance of the asset and another associated risk, according to Haider, J., & Azhar, M. (2011) is on the maintenance of asset. If the assets are properly maintained then the return to the certificate holders will definitely increase. According to the *hadith* above, it is understood that the owner of the securitized asset is liable to any maintenance requirement to the asset. Therefore, in *sukuk* structure, as the transfer of ownership is now in the hand of the shareholders, thus, the shareholders are responsible to any maintenance charge associated to the asset. However, there is another *syariah* mechanism which called *wakalah* (agent) which allows the owner of the asset to transfer the right of maintaining the securitized asset back to the issuer with certain fee is charged to the shareholders' return.

Profit Reserves Account

This account is actually meant for equity-based or profit-based *sukuk* such as *musyarakah* and *mudharabah sukuk*. Profit reserve account was created to act as a "sinking fund" which originally set up to credit any of excess income from the Trust assets which will later be used to fund payments of the periodic distribution from time to time to the extent that there is insufficient income from the Trust assets to pay such periodic distribution amount. According to AAOIFI FAS 17, "any unrealized gain or loss resulting from re-measurement at fair value shall be recognized in the statement of financial position under the 'investment fair value reserve'". The standard makes a provision that if the institution has reserves resulted from the adequate profits gained from the previous financial periods, it will be used to meet future investment risks and it goes otherwise as well which means if there is a loss resulted from re-measurement of investment at fair value, then it shall also be deducted from this reserve (Abdul Rahim, 2003).

The use of Hybrid Sukuk

Hybrid *sukuk* as an alternative to the debt-based *sukuk* is seen to be a potential way of getting funds with a lower cost. It is a combination of two or more debt-based *sukuk* structures in one *sukuk* project. The first hybrid *sukuk* was initiated in 2003 by Islamic Development Bank (IDB), Jeddah where the combination of *ijarah sukuk, murabahah sukuk* and *istisna' sukuk* were used. The example of hybrid *sukuk* as applied by IDB can be seen in figure 3. NorFadhilah (2011) found that this hybrid *sukuk* in theory has a potential to become a financial instrument which is more competitive, more effective risk control and able to mobilize funds better. What is special about this hybrid *sukuk* is that it can be traded in the secondary market at a discount price compared to pure structure of debt-based *sukuk* with the condition that the *ijarah sukuk* take part 51% of the total asset composition. This is meant to avoid *riba*. If we want to talk about this hybrid *sukuk* in detail, it is going to take another research paper to discuss on this subject. However, if a company to choose this instrument as a way to finance their project and to strengthen the credit management for *sukuk*, it might be one of the better choices.

CONCLUSION

Sukuk is the most growing part in the Islamic capital market and as strong as its name and bright image, *sukuk* brings along with it some major risks such as, default risk, regulatory risk, credit risk, liquidity risk, market risk and *syariah* compliance risk. Despite of knowing this reality, *sukuk* still catch the eye of the capital market player around the world. One of the main reasons is because *sukuk* has established its own identity in the world financial market. Whoever involves in *sukuk* issuance might get mass publicity and media coverage thus builds their company name.

As for default cases that happens and worries the Islamic capital market player especially *sukuk*, the more important thing is that the defaults that happens is not due to the *sukuk* structure but the way the institution's management deals with the credit risk management framework. It is important to ensure that the rating will not be downgraded at the next rating requirement. Here is where the credit risk management team of the institution plays a vital role. Skill, knowledge and experience are very important and this is where we are still lacking even though we are the center and source of information on the subject of *sukuk*. The best strategy to help improving the situation is by strengthening the existing indicators and even more indicators are needed and to be explored to help solve the default problem especially with regard to credit risk management. Looking at how *sukuk* is performing now and where it is heading to, it is believed that market player will become more and more matured in solving defaults. Businesses will quickly learn from previous experiences and soon new idea will come to improve the *sukuk* structure as well as risk management in *sukuk* so that defaults will not happen in the future.

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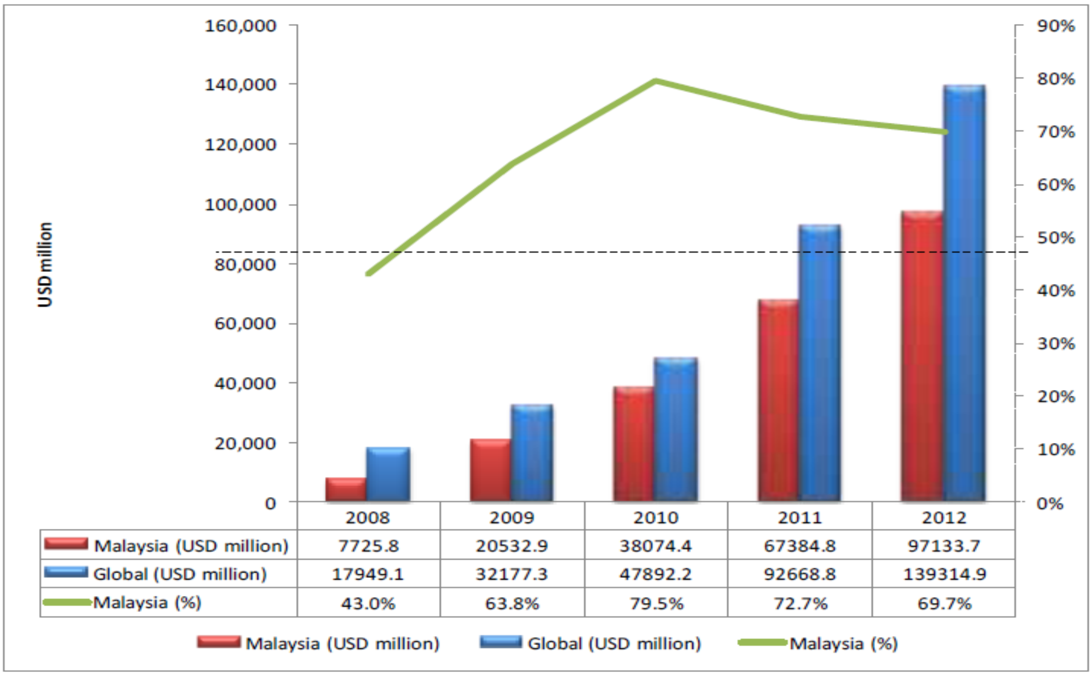
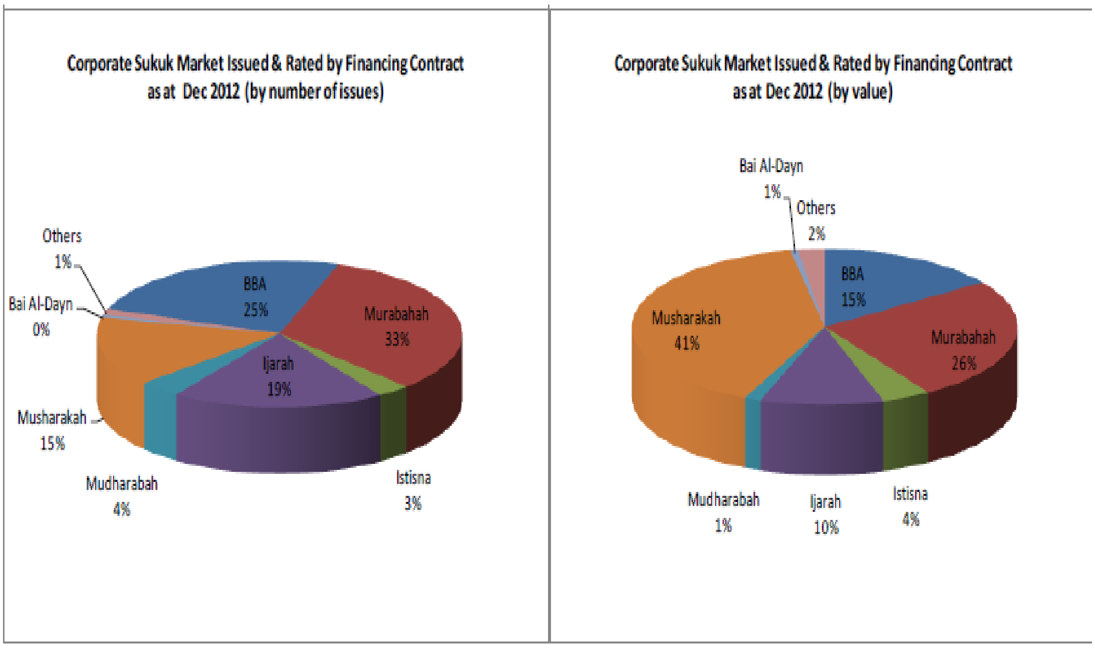


Source: RAM *Sukuk* Focus February 2013

CHART 1- *Sukuk* issuances from 2008 to 2012



Source: RAM *Sukuk* Focus February 2013

CHART 2- Malaysian *Sukuk* Market as been rated by RAM

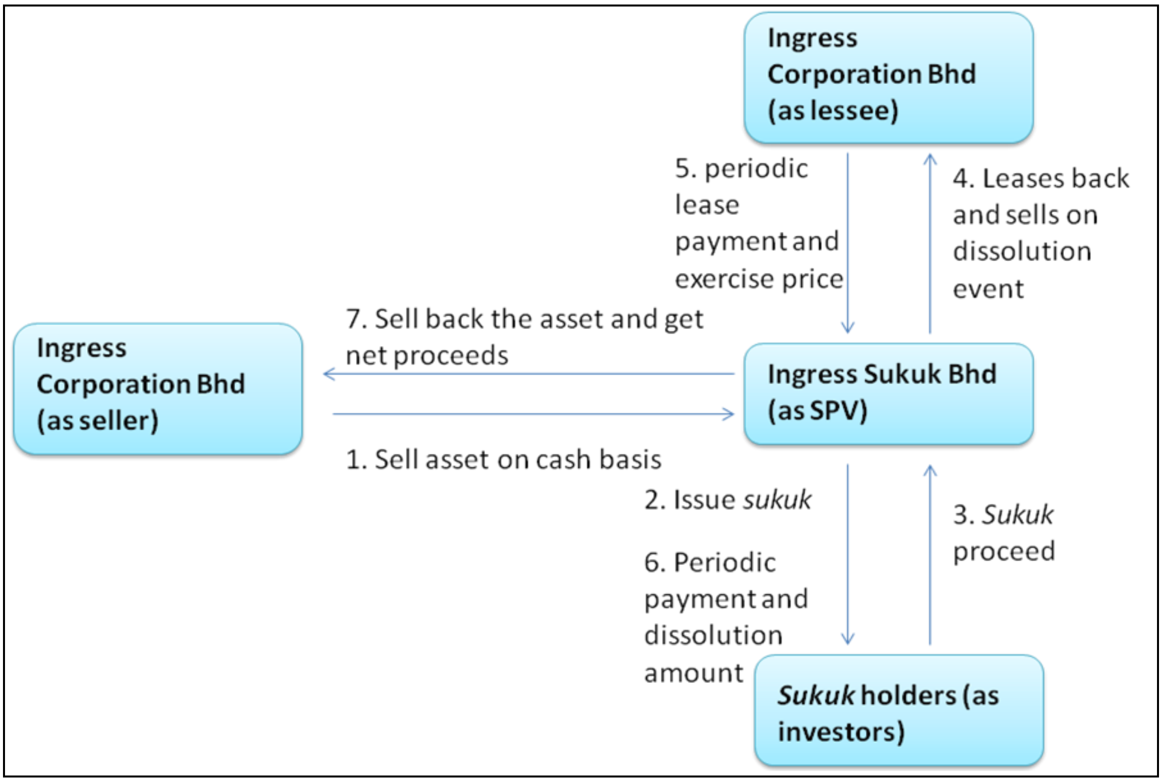
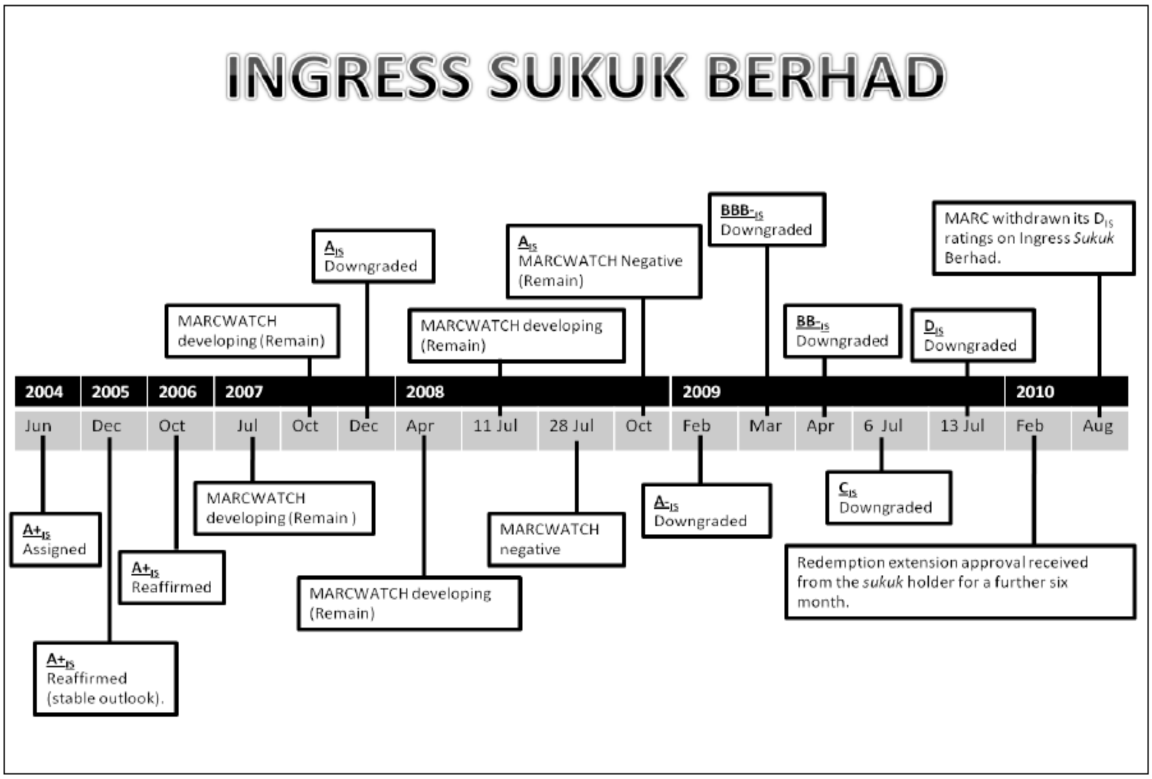
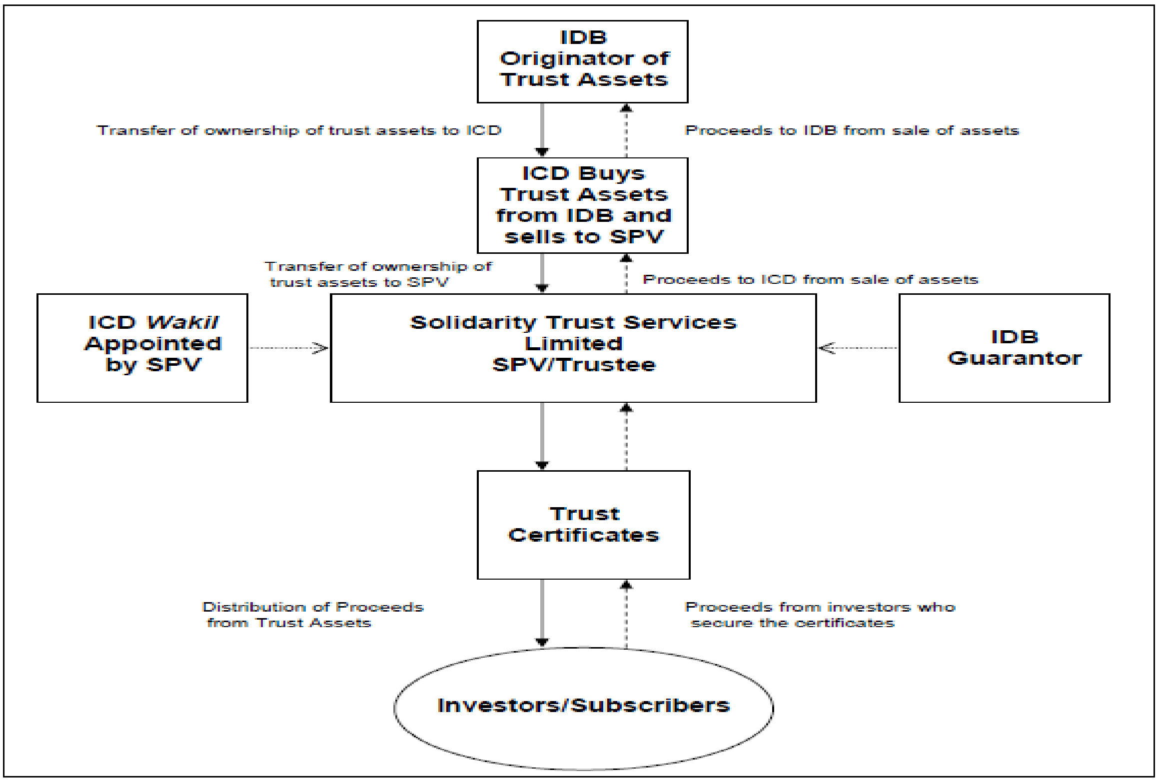


FIGURE 1 - Ijarah Sukuk Structure by Ingress Corporation Bhd



Source: Hafizi et al. (2012)

FIGURE 2- Ingress Sukuk Bhd Rating Timeline



Source: Tariq, A. A. (2004)

FIGURE 3 - IDB Hybrid Sukuk Structure