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The Influence of Corporate Governance, Financial Ratios, and Sukuk Structure on Sukuk Rating

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Abstract

The objective of this study was to provide empirical findings whether corporate governance, financial measures, and sukuk structure have a significant influence on sukuk rating. This study finds some interesting results. The board size has a positively significant influence on the corporate governance in relation to sukuk ratings. The study also demonstrated that financial leverage is negatively related to financial measures and sukuk ratings relationship. The study also demonstrated that sukuk ijarah is positively related to sukuk structure and sukuk rating relationship. The empirical findings are based on a sample of 25 Malaysian publicly traded firms rated by Malaysian rating agencies of RAM and MARC equivalent to S&P over the 2008 and 2012 period. The selected sample is representative enough in that rated and non-rated firms share similar characteristics in terms of (i) their stock return distribution, (ii) the profits they generate, and (iii) their industry distribution in similar industrial sectors.

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Keywords: Corporate Governance; Financial Ratios; Sukuk Structure; Sukuk Rating; and Islamic Finance

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1. Introduction and Background of the Study

There are several empirical evidences documented in the academic world indicating that sukuk issuance play significant roles in Islamic bond ratings (hereafter referred to as sukuk ratings). In the earliest years of the twenty-first century, Islamic finance took root particularly in real estate and private equity for which these areas of investment were chosen because of market opportunities and the particular expertise and preferences of Middle Eastern investors (McMillen 2007). In the modern economy, sukuk market and sukuk are an integral part of the financial sector and effectively supplement the funds provided by the banking sector (Sukor, et al. 1970). In the year 2003, real estate investments began to be made on a significant scale in Europe following seminal Shariah-

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compliant, combined with sukuk offerings as results of the acceleration of sukuk issuance in 2001 and 2003 (McMillen 2007). However, earlier studies tended to focus on the technicalities of sukuk market development especially in Southeast Asia after the financial crisis (Sharma 2001). From the conventional perspective, bonds (sukuk) can be defined as a long-term contract under which a borrower agrees to make payment of interest and principal, on specific dates, to the bonds holders (Sukor, et al. 1970). Sukuk are defined as "the certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity" (Finance 2008) (p, 43). "Sukuk are actually certificates or documents of debt issued by a government or an organization for an amount of money they borrow from the bondholders, promising them that it will pay back the money it has borrowed, usually with interest" (Sukor, et al. 1970) (p.86). According to S & P "Sukuk or Islamic notes is a number of Islamic law compliant activity, mostly delivered by sovereign, supranational, regional, or in other circumstances, government-backed entities or, a type of obligations delivered for Shariah-compliant activity (Archive 2006, 1).

This study investigates the relationship between corporate governance, financial ratios, sukuk structure and sukuk ratings to determine the levels of the relationships using Malaysian publicly held firms. Each of the relationships yields different results since they are affected by different corporate mechanisms and the goal of this article is to explore each of these different mechanisms to provide empirical evidences. Previous empirical studies reveal divergent views of researchers on the issue about the relationship between corporate governance, financial measures, sukuk structure, and Sukuk Ratings. These inconsistencies and the limited studies on this area in Islamic finance become motivation to conduct this study. The rest of the paper is organized as follows: section 2.1 below reviews the role of sukuk rating in sukuk markets and theoretical framework, followed by elaboration of the effect of corporate governance, financial measures, sukuk structure, on sukuk ratings in section 2.4. The methodological processes are discussed from section 3.0. Section 4.0 presents the empirical results and analyses as well as discussions of the results. Finally conclusion with limitation of the research of the study and some recommendations are provided in section 5.0.

2. The Role of Sukuk Rating in Sukuk Markets

Sukuk ratings of a firm, also conventionally known as credit ratings or bond ratings of a firm are determined by the assessment of the probability distribution of future cash flows to bondholders of the rating agencies, which in turn, depends on the future cash flows to the firm. Two basic types of sukuk ratings can be found in the literature. They are those sukuk ratings, designed for specific debt issues or other financial obligations applicable in sukuk markets and those sukuk ratings for debt issuers applicable in sukuk markets (Huang, et al. 2004). The former is the one most frequently studied and can be referred to as a ''bond rating'' or ''issue credit rating.'' It is essentially an attempt to inform the public of the likelihood of an investor receiving the promised principal and interest payments associated with a sukuk issue. The latter is a current opinion of overall capacity of issuers to pay their financial obligations, which conveys their fundamental creditworthiness (Huang et al. 2004). Ashbaugh-Skaife, et al 92006) demonstrated that the creditworthiness of a firm is determined by assessing the likelihood that its future cash flows will be sufficient to cover costs of debt service and principal payments. Faulkender and Petersen (2006) stated that bond market access is an important determinant of financial leverage. (Graham and Harvey 2001) reveal that credit ratings are the second most crucial factors influencing a firm's debt policy. This rating can be referred to as ''counterparty sukuk ratings,'' ''default sukuk ratings'' or ''issuer sukuk ratings'' (Huang et al. 2004). The default sukuk rating can be assumed for short horizon of one year, whereas the sukuk ratings'' or ''issue sukuk ratings can be assumed for long horizon (Altman and Rijken 2004). Further, Definitions of these ratings are released by these rating agencies, which they themselves are firms, but these firms are not 'buy', 'hold' or 'sell' indicators (Altman and Rijken 2004).