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## **Sukuk Default: Could Corporate Governance & Sustainability be the Defenders?**

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**Abstract:** 2009 was the default year of Malaysian sukuk. It grew larger due to blind market information about defaults, summing up the loss of USD 2.243 billion. Malaysian sukuk market still survived mainly due to petro-dollars and no competition pressure. By 2010, IMF and World Bank were unanimous to say that Malaysia had won the rightly envisioned status of global investment hub. More than 25% of sukuk assets, placed with her and 84% of short term sukuk are in MYR, certainly contributive to her GDP. By 2015 the sukuk market has entered into consolidation phase, with lesser issuances, stark down petroleum prices, sluggish post-crisis economy, down rated MYR, inflation and much higher competitive pressure. Saudi Arabia got IMF support for sukuk and Bahrain doubled its market share in a single year. This time the market forces would not relax Malaysia. Getting lesson from 2009, before the contagion ignites it is the time to check our safety measures against the default. Basing upon the logics drawn from extensive past literature this concept paper sorts the Corporate Governance (CG) and Sustainability (CS) for defensive mechanism against the defaults. Their inter-relation and relation with default risk have been discussed to reach over a conceptualized framework. It was observed that the CG-risk models are alone insufficient to make a plausible conclusion. CS has straightforward defensive role against defaults. But CG is clear to control CS. To say that CG-risk relation is better performed via CS performance. The discussion has been concluded in the managerial implications and directions for future research in the related fields.

### **Introduction**

IMF has reported that Islamic finance has emerged as a reality in the daylight by showing its mettle and resilience against the recent financial crisis. Although its market share is just a niche so far, but its rapid growth has rendered it a significant penetration in the global market and especially in the Asia. The report goes on to state that Islamic finance and maintain its gleam and glosses by making the sukuk markets more efficient and resilient. The sukuks are important for Islamic fiancé since other Islamic financial institutions must depend on it for their liquidity and profitability. Therefore, it counts for a 95% portion of global Islamic financial assets if sukuk assets are merged with Islamic banking assets. Secondly, it has a potential to grow more rapidly owing to its viability and outreach across the political borders (IMF, 2015; Ramadan, 2013; Suriani, Majid, & Nazaruddin, 2018). Asia Bond Monitor of Asian Development Bank tells its average growth rate is 27.8%, (Mohammed, 2015)..

But that is only one side of the story. All is not perfect and promising in the sukuk markets. The jerks and jolts are there in its way. IIFM annual Sukuk report of 2015 says that the sukuk growth by 2012 and 2013 had been at its trajectory and by 2013 it got it high peaks with record issuances. Report terms that the sukuk has entered the “consolidation phase”, where a range of external factors have started pressing the sukuk market negatively (IIFM, 2016, p. 3).

Only in Malaysia there was a series of defaults between 2000-2013 numbering 26 default cases. The highest defaults occurred in 2009. It was such a worse year in the history of capital markets of Islamic finance that researchers have coined it as the year of sukuk defaults (Shahida, Hafizuddin Syah, Daud, & Hafizi, 2014; Kamarudin, Kamaluddin, Manan, & Ghani, 2014). Researchers have also noted that these defaults have given a down swing in the sukuk market by impacting its issuances negatively (Majid, Shahimi, & Abdullah, 2010).

Khinfer (2010) narrates that during his data collection on sukuk default, not only he from the academic circle, but also the personnel in the law firms and the credit rating agencies were mainly ignorant of the number of cases of sukuk defaults, since a few cases only were in the lime light. And lamenting it was when the researcher dug up with 21 defaults only in the short span of 20 months, means at least one default per month. 15 sukuk issuers were wrecked only in 2009 and the 6 cases flooded in coming 11 months. Lamenting was the want of knowledge in popular circles, and even more lamenting was the situation that true picture had been revealed by no ombudsman or regulator. Would the industry have not “turned blind” in alarming the stakeholders after the first default, the situation might have been different to not shake the industry like the economic jerks it received (Khnifer, 2010). For the defaults by 2012, Sukuk industry had paid the price of this negligence, in shape of a loss of USD 2.243 billion only in Malaysia (Kamarudin, Kamaluddin, Manan, & Ghani, 2014). Once the defaults have occurred it can easily spread to the market. The default in the payment caused by one party can lead to the potential receiver to default as well for its obligations. Therefore, it become contagious. It becomes necessary to be prepared and discussing the mitigating tools beforehand. It can give an updated and timely picture of defaults and it can give an important input for decision making that what tools can be relied to what extent for credit risk management (Khalid, 2007; Saad, Haniff, & Ali, 2016).

As discussed in preceding lines, sukuk has an eminent place in the financial market, yet owing to a relatively new phenomenon, studies upon it are limited. Taking the default measures as a focused issue and checking the impact of corporate governance and sustainability is vacant in the literature at all. Hence this research aims to bring forward the conceptualization of the role of Corporate Governance (CG) and Corporate Social Sustainability (CS) in defending against the evil of default in the scenario of sukuk issuance.

The next sections aim to highlight the role of CG and the CS in aforesaid directions. Then the discussion will be able to boil down to certain conceptualized scenario for forecasting the sukuk defaults. The significance of CG and CS are discussed in the upcoming sections. This discussion in the proceeding section is boiled down to conceptualize their standpoints in forecasting the sukuk defaults.

### **Role of Corporate Governance in Default Risk**

CG is the set of internal rules, codified or precedential, to manage the functioning of a firm by operationalizing the inter-relations and hierarchy of personnel and the directors. CG has been praised by the past researches for its significant impact to efficiency, cost of equity and the firms' values. But

establishing the empirical links between the CG and defaults had been an under-researched area (Bhagat & Black, 2002; Bhagat, Bolton, & Romano, 2008; Gompers, Ishii, & Metrick, 2003; Chen, Chen, & Wei, 2011; Akdogu & Alp, 2016; Ijeoma & Ezejiofor, 2013). Hence the overall arch building from the concerned literature is not concrete and needs a bit more bricks and mortars, yet it can be augmented plausibly that CG structures are important for sukuk credibility (Elhaj, Muhamed, Ramli, & Zakaria, 2016).

Gompers, Ishii, & Metrick (2003) divided the stocks into two portfolios the Democrats with high CG level and Dictators with lesser levels of CG. It was noted that the stock returns on the Dictator stocks were greater. It is plausible to imagine that the stocks with lower CG implementations were at higher level of risk and therefore paying more on the risk premium. It was also noted that in the absence of CG implementations, agency issues can get bigger and the cash usage for the CEO remunerations (Core, Guay, & Rusticus, 2006). These two factors can increase the default risk on aggregate.

The cash holdings in the corporates can be another viewpoint to probe the relation of CG to default risk. The free and idle cash can impede the firms' profitability with a double edge sword. It can decrease the investment size and renders a heaven to CEO to benefit from the cash other than the remunerations. It was noted by some studies that the CG, measured by antitakeover mechanisms, can decrease the unwise cash holdings (Yun, 2008). While if the CG is measured on bigger range of its constituents, it was noted that the CG is increasing the risk of holding more cash (Harforda, Mansib, & Maxwell, 2008).

Specifically focusing on default risk, it was exhibited by a study that the board independence and institutional ownership is inversely related to the risk. The Risk was measured by Merton model. Once the risk was measured by the proxy of CD spreads. The relationship of board independence became insignificant (Switzer, Wang, & Tu, 2016). On the other hand, CD spread was decreased by the antitakeover mechanism of CG (Akdogu & Alp, 2016). Another study took a long list of CG variables at independent side and the default risk was the dependent variable. It was noted that only some variables were showing the significant results. Board composition with smaller size, gender diversity and independent directors decreased the default risk while the institutional ownership had a positive effect on default closeness (Cao, Leng, Feroz, & Davalos, 2015). It was further noted that the CG impact on default risk is insignificant once the endogeneity issues are controlled by GMM (Schultz, Tan, & Walsh, 2015).

Overall the directors can be unable to bring down the level of risk in an organization. Every organization has a risk culture and an appetite for taking the risk and return combinations. This risk culture is stubborn and can not be reversed especially once proven effective for profits. All the shareholders are not able to understand complex risk calculations they can merely assume the returns added to it. They support the directors good in taking risk according to their own preferences. CG measures are also aimed to protect shareholders mostly. Risk is managed in accordance with the competitive market culture not by the boards (Fahlenbrach & Stulz, 2011; Iqbal, Strobl, & Vähämaa, 2015; Mehran, Morrison, & Shapiro, 2011). The board is compelled to take risk even after the threshold level of credit stress has been crossed (Fich & Slezak, 2008). While Ben Zeineb & Mensi (2018) has noted that the risk taking is further increased by the free-rider issues in the board members. On other hand "dark side expertise" of the board can be another medium to increase the risks. The directors are paid for their skills not to manage the risk instead to rectify the risk levels the organization wants to take. Their remunerations are paid by the corporates so they have to follow them (Mehran, Morrison, & Shapiro, 2011, p. 10). The hypothesis of dark side expertise was further

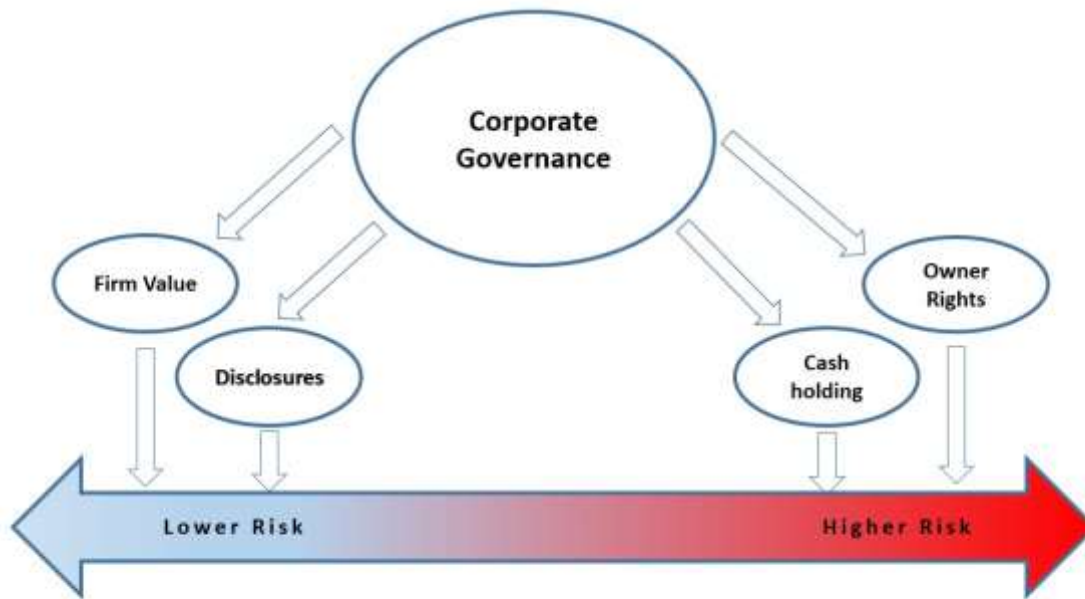
reasserted by the empirical evidences of related studies (Minton, Taillard, & Williamson, 2014; Iqbal, Strobl, & Vähämaa, 2015).

Overall the relationship of CG to default risk is biangular. The CG can increase firm value that results in the risk decrease (Chen, Chen, & Wei, 2011; Gompers, Ishii, & Metrick, 2003). While From the angle of shareholders' empowerment it can cause an increase in the risk (Vateva, 2014). The impact of CG upon default risk is conceptualized to have is positive, with respect to shareholders or owners right and cash. While this relation is expected to be negative via the firm value and disclosures. Is it possibly to camping the two opposite poles at the same time? These two probable relations as envisioned in the above discussion are mutually inconsistent. Having said it clearly means the model specification is not satisfactory up to the current body of knowledge. It clearly calls for two steps. Firstly, the selection of GC variables must be cautious one under the nature of the study and context. Secondly, the modeling should be better done in path analysis by the inclusion of a new and related variable. Can the variable of CS be expected as significant variable here for the discussion of GC and default risk? This study shows in next sections that the inclusion of the CS variable can be a good choice.

### **Role of Corporate Social Sustainability in Default Risk**

Sidney Homer an affiliate to the Salmon Brothers, is considered as the father of research in financial bonds. He narrates that the history of bonds dates to 1550, but the stakeholder pressure being faced by the issuers is the highest one in whole course of the history. Stakeholder management by engaging in social projects gives a positive fame to the market players and an acceptance among the public at large. It allows a low-cost capital to the issuers in primary market and a liquidity in the secondary market as well. Market place is hence not for "deviants" in continuing their business without having a well place, not merely theoretical but operationally effective, for the standards "accepted and indeed dictated by the community as a whole" (Homer, 1975, pp. 388-389). These positive reasons have encouraged the boards and the managers to welcome the CS activities in their daily working. The researchers have also responded well on the issue but still the link between the default risk and CS performance is not much researched. For instance meta-analysis covered on the relationship between the CS and risk are vacant to cover the default risk (Orlitzky & Benjamin, 2001; Wang, Dou, & Jia, 2015)





**Figure 1: Biangular impact of CG upon Risk**

The CS performance of the firms can bring loyalty among their customers. The purchases decisions of these loyal customers are less effected with the negative shocks. This lower elasticity of demand can bring a stability in the earnings and decreases the risk. It was also noted that these firms have lesser administrative expenses and hence a stable operating leverage (Albuquerque, Durnev, & Koskinen, 2015). CS activities also yields a better relationship with the regulating and supervisory bodies. The CS concerns makes the firms ethical and efficient in compliance even more than the minimum legal requirement. That way the firms can enjoy less legal risk and lesser penalties imposed on them (Wang, Lin, Kao, & Fung, 2016; McGuire, Sundgren, & Schneeweis, 1988). CS performance makes the firms better in their competitive behavior to the fellow market players (Spicer, 1978). It can make them efficient in their supply chain management and credit purchases.

The CS projects can be of varied nature. Generally, they rest upon three bigger pillars, viz; economic, environmental and social CS. All of these have their abilities to lessen the risk level of the firms. Economic CS being the bases of all other projects has its central importance. It was noted that the economically sustained business can bring the social and environmental sustainability in its operations (Carroll, 1991; Nasir, Halim, Sallem, Jasni, & Aziz, 2015). It was noted that this phenomenon holds true for the macro level too. The countries better in their economic sustainability were noted to have better performance in other domains of CS. While studies have also shown that economic CS can bring decrease in the firm risk significantly (Torugsa, O'Donohue, & Hecker, 2013; Weber, Fenche & Scholz, 2008)

Environmental performance is an important constituent of CS performance. The World Bank has recommended that the environmental performance must be made a part of the credit evaluation of the borrowers. Hence, the borrowers with more environmental-friendly strategies would have to pay a lesser risk premium and can enjoy low cost debt (Weber, Fenche, & Scholz, 2008). It was also noted

by empirical findings that the environmental CS performance can reduce the firm risk (Benlemlih, Shaukat, Qiu, & Trojanowski 2018; Suto & Takehara, 2018).

Social dimension of CS makes the firms responsible in their employee retention & turnover by paying a proper attention to benefits provided to employees and occupational health and safety. Therefore, these firms are observed to have lesser HR issues (Soloman & Hansen, 1985). These HR efficient strategies of the firms make them able to manage their risk levels more easily. It was found that the social CS performance impacts the firm risk negatively (Benlemlih, Shaukat, Qiu, & Trojanowski 2018; Suto & Takehara, 2018).

Foremost and directly taking on risk Wang, Dou, & Jia (2015) carried out a meta-analysis from the past literature to elucidate the relation of CS performance to the risk profile of relevant company. The analysis was arched upon the instrumental theory of stakeholders. Theory relates the stakeholder management activities to the final goals a business needs to achieve as the part of its strategy. It tells that the business if takes care of the stakeholders, the pays-off are back to the shareholders via making the business to achieve its goals more efficiently. Instrumental relation between the CS and risk was the focus of the study in terms of the direction of the relation. This direction of cause and impact relation was assumed reciprocal. By the data analysis of large across the country analysis, it was noted that impact was not the bi-directional.

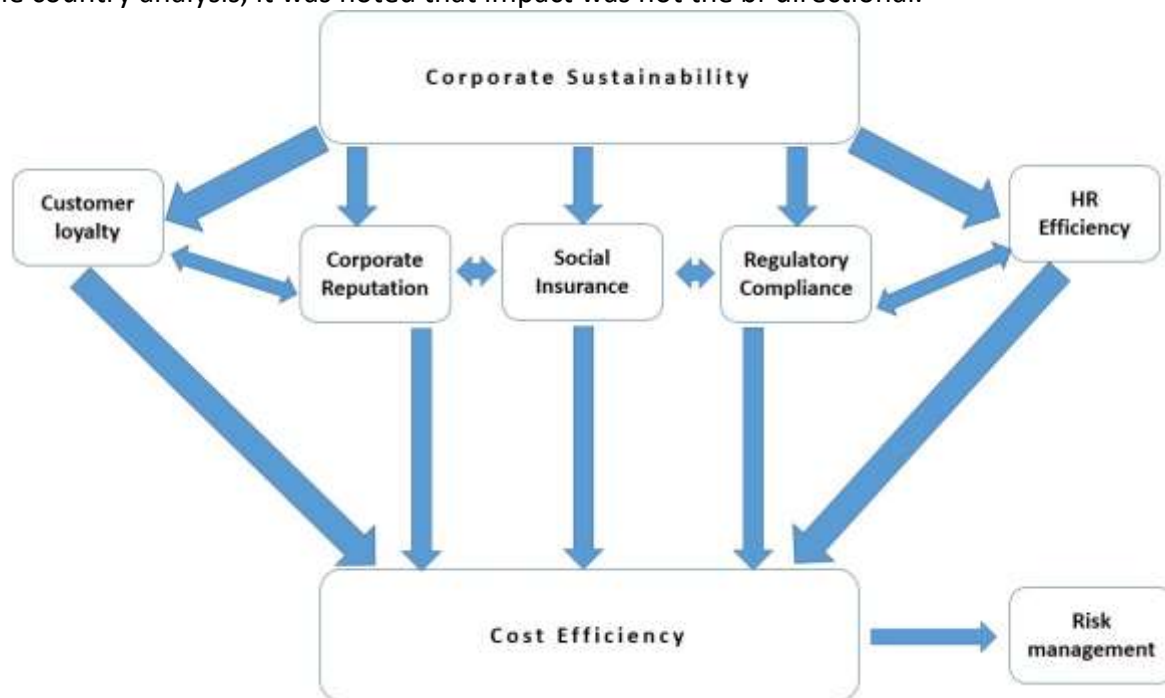


Figure 2: Impact of CS upon risk via multi factors

### Special Status of Sukuk

The Islamic financial products and investments are thought to be resilient ostensibly. They are considered safe to take more risk because they are safe for it because they are built upon profit and loss sharing (PLS) theory. The Islamic financial industry is built upon the principle of no usury or interest. The alternative mechanism was missioned on two-tier PLS. That the investments and profits both on the asset and liability sides, will be welcomed on PLS, while, the managing institute will keep its margin (Usmani, 2009; Abdul-Rahman, Latif, Muda, & Abdullah, 2014). Based on this model it is

widely assumed that Islamic financial industry is resilient against risk taking, since it shares its risk with investors (El Haloui & Aboulaich, 2019). The foundations of Islamic finance make the system at macro level more responsible for economic sustainability and at the micro level resilient and agnostic to the credit stress (El Haloui & Aboulaich, 2019). This risk hypothesis gained its fame in the post-crisis era once most of Islamic banks showed their resilience against the fall in crisis. This study argues that this assumption is unrealistic. Firstly, merely compliant to PLS mechanism is not enough, as witnessed by the series of sukuk defaults and losses. Secondly, this theory is not applied in many Islamic financial products. The major assets of Islamic financial institutes are managed on non-PLS mechanism. That makes the Islamic financial products as susceptible to defaults as the conventional counterparts.

Specifically, in the case of sukuk, it was exhibited based on empirical data, that the sukuk based on PLS theory are launched to reduce the information asymmetry risk. The issuers once confronted with uncertainties due to want of information, they choose PLS sukuk to share their risk with investors (El-Khatib & Patel, 2009). Financial indices like Dow Jones, S&P, FTSE, MSCI, etc. have witnessed that the investors' confidence is increasing in Islamic investments after the crisis (Alqahtani, 2009). While, specifically talking about sukuk, the investors' confidence is highly in the favour of the industry. The sukuk are 4 to 6 times oversubscribed (KIB, 2019; Ace Group, 2016; BNM, 2015). Sukuk issuances in this scenario provides the issuers a dependable trail of financing. Assuming that they are naturally resilient against the risk and are oversubscribed, can induce the issuers to think that they are too big to fall. It can induce the issuers to take more risk (Colan, 2017). Too big to fall is a managerial assumption as a moral hazard that encourages the big firms to take risk on the intuition that even the biggest risk are worth nothing to worry, owing to their big size (Acharya & Thakor, 2016). Another phenomenon that the Islamic financial institutes are new entrants of the market they have to play aggressively to compete their older counterparts, triggers up their risk taking as well (Ben Zeineb & Mensi, 2018). It has been reported that the sukuk issuances in a market increases competitive pressure that trends other market players to increase their overall risk taking (Smaoui & Ghouma, 2020). In this wake the CG board members may allow them to take risk. These issues give the height in risk management process of sukuk and makes it akin to have a better CG measures (Elhaj, Muhamed, Ramli, & Zakaria, 2016).

### **Conclusion and the way Forward**

Sukuk is witnessing a promising growth. But to maintain its growth trajectory and veracity of investors confidence the need of the hours is to make it resilient against defaults. The past defaults have shaken the market with severe losses the aftermaths of the crisis are not over yet. Therefore, their closeness to defaults and the tools to analyze resilience must be updated timely. Getting lesson from 2009, before the contagion ignites it is the time to check our safety measures against the default. Basing upon the logics drawn from extensive past literature the CG and CS are conceptualized to make the defensive mechanism against the defaults. The models with taking only CG as variable to tackle with risk ends up in a mutually inconsistent and exclusive biangular role of CG. This inconsistency is also the results of multifaceted nature of CG. Hence firstly the dimensions of CG be carefully selected. Secondly, the CS has quite appreciable mediating role while the CS is going to be controlled by CG and both are promising to manage default risk. Hence the impact of CG is better formulated through the CS. It is pertinent to note that both CG and CS must be taken together to have a holistic tool set against default risk.



Aras & Crowther (2008) argued that the CG and CS can be brought together on their theoretical underpinning. They define the CG "... creating a balance between the economic and social goals of a company including such aspects as the efficient use of resources, accountability in the use of its power, and the behavior of the corporation in its social environment (Aras & Crowther, 2008, p. 441)". The CS mandates the corporates to achieve their goals in economic, social and environmental aspects of CS, while the CG operationalizes these goals. Both are aligned in their objectives and complement each other in creating the economic value for the firm and decreasing the risk. This argument is based upon the stakeholder theory. While based on the agency theory it can be augmented that current scandalous corporate environment has highlighted the agency issues. The managerial authorities have taken the managers away from the ethical standards of stewardship. The CS projects, owing to weaker assurance and auditing, can be a safe haven for the managers. It can beget more scandals and agency issues. While if their powers are construed too narrowly, the CS performance cannot be made. That can be a risk on the basis of social sustainability. Hence, the authority and supervision are both necessary at the parallel. It paves the way for CG to control and manage CS activities in the favor of corporates (Heath & Norman, 2004). The relationship of CG to CS is also tested empirically in the past literature (Kolk J., 2008).

The nature of the study was qualitative owing to the concept paper a clear limitation. The findings are off course jeopardized to this limitation. Hence an empirical study in response to this research has already been started by the authors. Another point to ponder that CG must be incorporated carefully with respect to its dimensions and their role to risk. This point can be the object of an independent research that what dimension related to the analysis of what kind of risk. This analysis can be business specific too. For corporate sector the literature is abundant as compared to SME. The research can be carried for them too. Behavioral aspects of the board can also be incorporated. Moreover, CG and CS, their relations to risk were discussed through different ways and variables, e.g. cost affectivity, cash holding, etc. The supporting literature was not mostly a mediation analysis. Hence the empirical researches are crucial here to elucidate that what variable is related econometrically and what not in order to conclude with a composite model.

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