

Sukuk Defaults and Its Implication: A Case Study of Malaysian Capital Market

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Sukuk have become increasingly popular as a feasible and viable shariah-compliant long-term financing instrument. Being the leader in sukuk market, Malaysia is committed to evolve its financial services sector to serve the needs of businesses and consumers, as well as to increase its appeal in the regional and global market shares of selected niches, in particular, the sukuk market. Sukuk markets around the world are growing to becoming significant sources of capital even though a series of high profile sukuk defaults in the Gulf Corporation Countries (GCCs) had tarnished the market's confidence on sukuk. Malaysia had also recorded several cases of sukuk defaults such as of Johor Corporation, Ingress Sukuk Berhad, Tracoma Holdings Berhad and Nam Fatt Corporation Berhad. The issue of sukuk default is very crucial since it affects the welfare of its stakeholders. Identification of default risk in sukuk is important for supervision and risk management purposes. Certainty with regard to the post-default process in sukuk transactions is necessary because the risk for a default exists in all types of transactions. Even the most prudently structured products can fail due to circumstances outside investors' control. Therefore, this paper aims to discuss the issue of sukuk default and its implication on Malaysian capital market. At the same time, it also intends to investigate the implication of sukuk default on a country's reputation, the legal aspect and on the investor's protection. The impact of sukuk default on Malaysian capital market as a hub for global Islamic finance industry is also discussed comprehensively in this study. It is hoped that this study will help sukuk issuers and rating agencies for estimation of credit risk and setting corporate pricing on a risk adjusted return basis, as well as the regulators in ensuring market stability and efficiency towards sustainable economic growth.

Keyword: capital market; default; Islamic finance; Malaysia; *sukuk* rating.

1. Introduction

The *sukuk* market has grown rapidly over the last few years in terms of size, numbers and sophistication. *Sukuk* has become an alternative for conventional bonds and being used in financing for the last twenty years. It provides sovereign governments and corporations with

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access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base. However, the series of high profile *sukuk* defaults in the Gulf Cooperation Countries (GCCs) such as Investment Dar, Saad Group and Dubai World's Nakheel *Sukuk* in 2009, as well as the East Cameron *Sukuk* (US) have astounded the market's confidence in the global Islamic finance industry, provoking a debate on investors' protection and rights. Although *sukuk* is claimed to be more secured than the conventional bonds due to the requirement of physical assets to underpin deals, *sukuk* is now asserted to have lost credibility as a feasible and viable Islamic long-term project financing instrument. In the Malaysian context, despite being a leader in *sukuk* market, Malaysia has also recorded cases of *sukuk* defaults such as of Johor Corporation, Ingress *Sukuk* Berhad, Tracoma Holdings Berhad and Nam Fatt Corporation Berhad. Although *sukuk* defaults in Malaysia are not widely discussed, the issue raises concern on the investors' protection and the survival of Malaysian capital market in the future.

A default occurs due to the breach of any binding obligations under the original terms of the agreement between the issuer and the *sukuk*holders. Apparently, both contractual parties must fulfill their obligations under the contract or agreement. The complexity of structure and several legal issues may be significant on rating process, but from a rating perspective, assessing the risk of the issuer's inherent credit strength is fundamental to the final rating outcome. In other words, performance of the *sukuk* issuer highly affects the final rating on the *sukuk* itself.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) guidelines emphasize the difference between *sukuk* and conventional bonds. These guidelines indicate that *sukuk* does not represent a debt owed to the certificate holder by the issuer, so that the owners share in the returns and bear the losses. Furthermore, the standards state that the documentation must explicitly abide *shariah* (Islamic law) and that a *shariah* board of the capital market regulatory body must monitor its implementation.¹ Conventional bond default provisions that are frequently incorporated into *sukuk* documentation appear to provide investors with an Islamic instrument that is similar to the conventional bonds. While *fatwas*² are procured to provide comfort that instruments are *shariah*-compliant, such endorsements are subject to different interpretations. When *fatwas* contravene AAOIFI standards, their reliability becomes tenuous. Even when they may be compliant with a standard, which has been passed with a narrow majority, a structure may be called into question by the individual judge, who may subscribe to the strong minority view.

Rating on *sukuk* reflects the (credit) worthiness and stability of *sukuk*. By having the annual rating reviews conducted by the respective rating agencies, *sukuk* investors are adequately informed of the issuer's status and progress. In addition, the rating changes on *sukuk* may be significant to the possibility of *sukuk* default to a certain extent. Generally, *sukuk* with higher rating is unlikely to default and vice versa.

This study will discuss on the *sukuk* defaults in Malaysia and its implication on the Malaysian capital market with a special reference to the selected cases of Malaysian defaulted *sukuk*. This paper will follow qualitative or descriptive research method, related to the issues of *sukuk* defaults by selecting a few cases of defaulted *sukuk* that may affect the Malaysian capital market.

So far, studies on *sukuk* defaults are very limited as compared to conventional bond defaults. Hence, this study contributes to the literature by providing constructive discussion on *sukuk* defaults and their implication on Malaysian capital market. This study will benefit the regulators, investors, industry players and also researchers in this area.

The remainder of this paper is organized as follows; Section 2 deliberates on the *sukuk* insights. Section 3 outlines the research design. Section 4 discusses the *sukuk* development in Malaysia and provides an evidence of *sukuk* defaults. Section 5 presents the analysis and discussion of *sukuk defaults* and its implication on Malaysian capital market and finally section 6 concludes.

2. *Sukuk* Insights

2.1 *Sukuk* concept

Sukuk are among the financial instruments for raising funds and are vital vehicles for resource mobilization, whether in the public or private sector (Mohd Hafizuddin et al., 2010). According to AAOIFI (2002), *sukuk* refer to investment products and can be defined as “certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity”. As a certificate, *sukuk* is documented the undivided pro-rated ownership of underlying assets and the *sak* (singular of *sukuk*) is freely traded at par, premium or discount (Securities Commission of Malaysia (SC), 2010). Based on both definitions, *sukuk* can be further defined as commercial papers that provide an investor with ownership in an underlying asset. It is an asset-backed trust certificate evidencing ownership of an asset or its usufruct. It has a stable income and complies with the principle of *shariah*. Unlike conventional bonds, *sukuk* need to have an underlying tangible asset transaction, either in ownership or master lease agreement.

In economic terms, there are three common types of *sukuk*; namely fixed-income *sukuk*; asset-backed *sukuk* (ABS); and hybrid *sukuk* (Zawya, 2009). *Sukuk* can be of many types depending on Islamic contracts or principles of financing and trades used in the structuring process. AAOIFI has issued standards as guidelines for 14 different types of *sukuk*, which can be classified as tradable and non-tradable, development and industrial project financing. However, the most common principles used in *sukuk* structuring are *mudharabah*,³ *musharakah*,⁴ *murabahah*,⁵ *ijarah*,⁶ *BBA*,⁷ *salam*⁸ and *istisna*.⁹

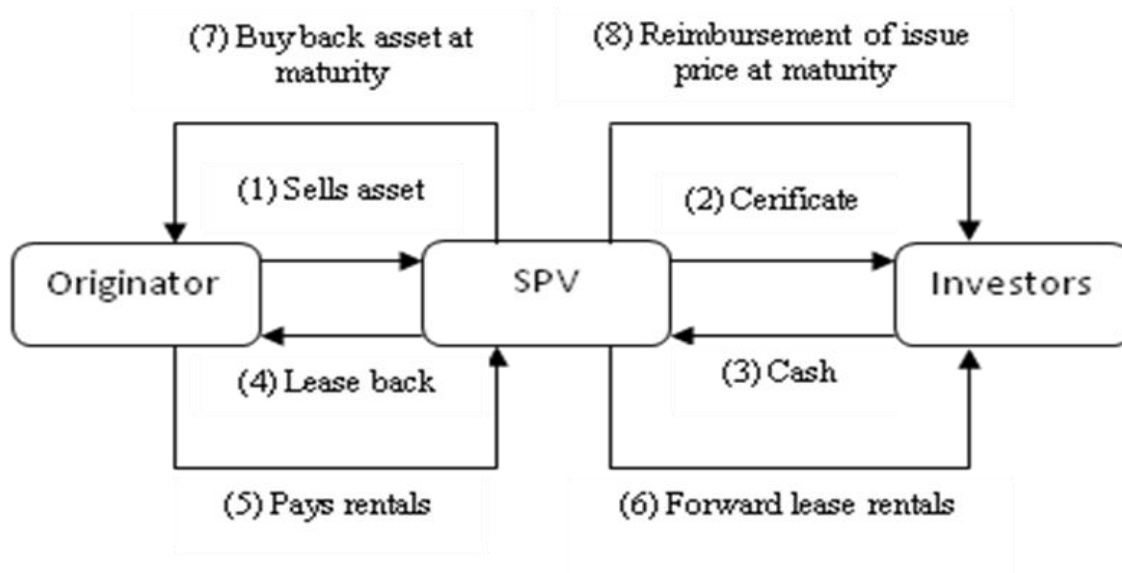
So far, among all the available structures, *sukuk BBA* and *sukuk murabahah* are the two *sukuk* with the highest default cases in Malaysia. In fact, *sukuk BBA* was the *sukuk* with the most issuance in Malaysia in 2004, before the Malaysian *sukuk* market got dominated by *musyarakah sukuk* beginning 2006. *Sukuk BBA* is a financial certificate based on *BBA* contract as evidence of ownership right of the investors on the underlying assets (Ab Ghani, 2006). This *sukuk* is not similar to bond because the latter represents debt obligation of the issuer. It is created to service the need for working capital or to re-finance existing debt, normally to be used in the transportation sector, especially in the shipping and aircraft sectors, real estate, construction, and also in the petrochemical projects.

In *BBA* structure, payment is deferred and final price should be contractually agreed and known to both parties, the time and mode of payment should be ascertained and there is no requirement to state the cost price and amount of mark-up. The issuer of this *sukuk* has the right to get fund from the investors, meanwhile the investors have right to resale the *sukuk* to another party to gain additional profit. If the real value of *sukuk BBA* is not suitable with the previous contract, the investors have the right to object and return it to the initial issuer.

2.2 Selected *sukuk* structures in Malaysian capital market

The Malaysian *sukuk* market took off in 1990 with the world's first *sukuk* issuance by Shell MDS. Since 2006, global demand for Malaysian *sukuk* has been increasing and the issuances are based on the globally accepted contracts of *mudharabah*, *ijarah* and *musharakah*. Since then, the market has expanded, not only in term of size but also sophistication that shows structures based on *ijarah*, *musharakah* and *murabahah* are now common in practice.

Ijarah is a *manfa'ah* (usufruct) type of contract, where the owner leases out an asset to a client, at an agreed rental fee and pre-determined lease period, as per the *aqd* (contract). Normally, the ownership of the leased asset remains in the hands of the lessor. Based on this structure, the *sukuk* holders own equal shares on the underlying asset (or its usufruct). Basically, the *sukuk* holders hold the right to own the asset and collect the rental payment or dispose the *sukuk* at any time (Noor Inayah *et al*, 2011). Again, these rights depend on the structure of *ijarah* whether asset-backed *sukuk ijarah* or asset-based *sukuk ijarah*. Asset-backed *sukuk* allows the holders to liquidate the underlying asset in the event of default to recover most of their investments (Noor Inayah *et al*, 2011). On the other hand, asset-based *sukuk* only represent beneficial ownership on the underlying asset and it restricted the holders' right in the event of default. Figure 1 shows the common structure of *sukuk ijarah*, which involves three parties i.e. originator, special purpose vehicle and the *sukuk* investors.



Source: Abstracted from Wilson (2008).

Figure 1: Basic Structure of *Sukuk Ijarah*

Steps in *Sukuk Ijarah* transaction

- (1) The originator sells certain assets to special purpose vehicle (SPV) at an agreed pre-determined purchase price.
- (2) – (3) SPV will raise funds to finance the purchase of the assets through the issuance of *sukuk* and sell to investors.
- (4) A lease agreement is signed between SPV and the originator for a fixed period of time, where the obligator leases back the assets to lessee.
- (5) – (6) SPV receives periodic rentals from the originator. These are distributed among the investors i.e. the *sukuk* holders.
- (7) – (8) At maturity, the SPV sells the assets back to the seller at a predetermined value. This proceed will be used to reimburse the certificate holder at issue price.

Meanwhile, the concept of *murabahah* has been used to develop an innovative Islamic finance contract, including *sukuk*. *Murabahah* refers to the sale of goods at certain price that comprised the purchase price and profit margin agreed by contractual parties. Thus, *sukuk murabahah* refers to the certificates of equal value issued for the purpose of financing the purchase of goods through *murabahah*. By doing so, the investors of the *sukuk* holders are the legal owner of the *murabahah* commodity. The issuer of the certificate is the seller of the *murabahah* commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the *murabahah* commodity and are entitled to its final sale price upon the re-sale of the commodity. *Murabahah sukuk* have, however, become popular in Malaysian capital market due to a more liberal interpretation of *fiqh* by Malaysian jurists permitting sale of debt (*bai-al-dayn*) at a negotiated price. Common structure of *sukuk murabahah* is shown in Figure 2.

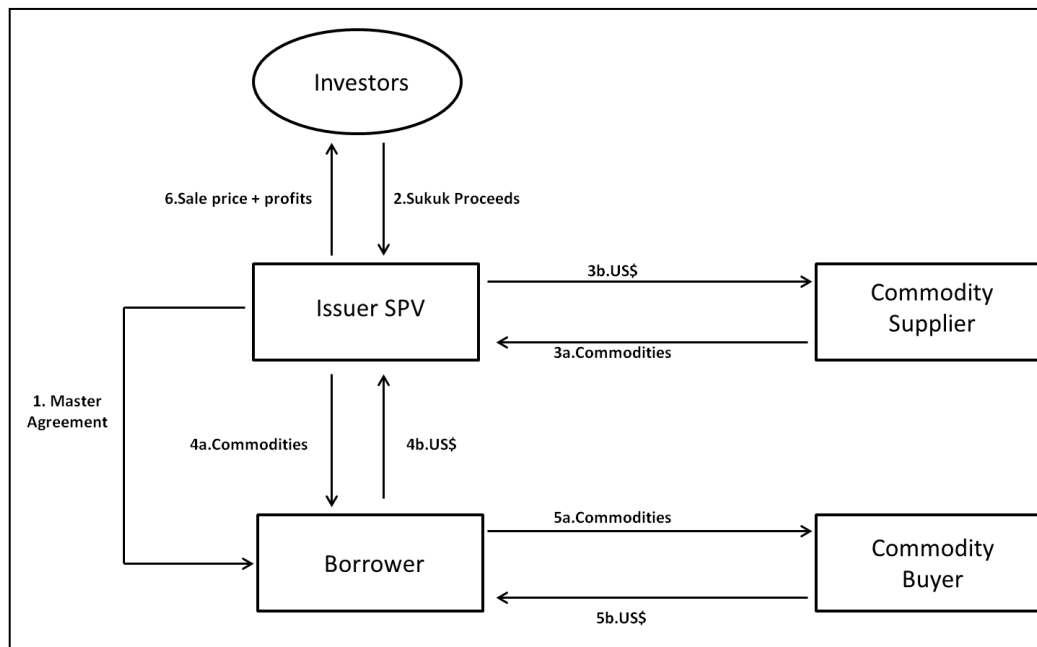


Figure 2: *Sukuk Murabahah* Structure

Steps in *Sukuk Murabahah* transaction

- 1 A master agreement is signed between the SPV and the borrower
- 2 SPV issues *sukuk* to the investor and received *sukuk* proceed
- 3a & 3b SPV buys commodity on spot basis from commodity supplier
- 4a & 4b SPV sells the commodity to the borrower at the spot price plus profit margin, payable on instalments over an agreed period of time.
- 5a & 5b The borrower sells the commodity to the commodity buyer on the spot basis.
- 6 The investors receive the final sale and profits.

2.3 Credit risk and rating

In the case of credit (default) risk, there is always a probability that a corporate borrower will not be able to meet its contractual obligations and may renege from paying the principal and the profit due. Even for the typical high-grade borrower, this risk still exists even though it may be very small, perhaps 1/10 of 1 percent per year. Although this type of risk does not seem large, it is in fact highly significant, and can increase quickly with little warning. Furthermore, margins in corporate lending are very tight, and even small miscalculations of credit risk can undermine the profitability of lending. Unexpected realizations of the risk have destabilized, de-capitalized, and destroyed many international corporate institutions.

In Malaysia, all debt securities including *sukuk* issues are required to be accompanied by a credit rating at all times. A credit rating is a mechanism through which an independent third party, i.e. the credit rating agency (CRA),¹⁰ makes an assessment on the likelihood of a corporate issuer's default on its debt repayments. It focuses on a specific debt instrument and not the overall creditworthiness or financial standing of the corporate issuer. A rating will take into consideration various enhancement tools like guarantees, sinking funds, letters of credit or any other mechanism devised to reduce the default risk of specific issues. Thus, a corporate may be assigned different rating categories for different debt issues across time (RAM Ratings, 2010). However, rating is not a recommendation to purchase, sell or hold a security's market price or its suitability for a particular investment, nor does it involve any audit by the rating agency (RAM Ratings, 2010).

Malaysia is one of the first few countries in the world to require the recognition of CRAs for the purpose of rating a bond or *sukuk* issue. This is in recognition of their vital role in evaluating the probability of default of *sukuk* issue, and the importance investors place on ratings for their investment decisions. CRAs are required to be recognized by the SC for the purpose of rating debt or *sukuk* issues in Malaysia, pursuant to the Guidelines on Recognition of Credit Rating Agencies by the Securities Commission for the Purpose of Rating Bond Issues.

2.4 Rating performance and *sukuk* defaults

Bandyopadhyay (2006) reports that as the credit quality worsens i.e. decline in the rating grades, the probability of default (PD) increases. Furthermore, the PD jumps sharply as soon as the rating move from investment to non-investment grades (i.e., from BBB rating to BB) and that justifies the reason for a study on the rating performance and *sukuk* defaults. He also observes that rating stability declines as the credit quality worsens. The higher risk in the bottom grades

(mainly non-investment grades) calls for developing a corporate default predictor model that would better capture the firm's characteristics and could give an early warning signal of corporate distress. This issue is very relevant and significant not only for conventional corporate bond, but also for *sukuk*. Furthermore, in the wake of a series of high profile *sukuk* defaults in the GCCs, such as Investment Dar, Saad Group and Dubai World's Nakheel *Sukuk* in 2009, *sukuk* are alleged to have lost credibility as feasible and viable Islamic long-term project financing instrument (Raja Teh Maimunah, 2010).

3. Research Design

This paper will follow qualitative or descriptive research method, related to the growing issues of *sukuk* defaults by focusing on the development of theory through a case study approach (Eisenhardt, 1989; Yin, 1994). The ultimate objective of the study is to provide an understanding on the default cases and its implication on capital market. The general discussion on Malaysian defaulted *sukuk* will cover the period of 1997 to 2010 (14 years).

This paper will discuss on the selected defaulted *sukuk* cases. For this purpose, a *Murabahah* Islamic Debt Securities issued by Johor Corporation, *Sukuk Ijarah* issued by Ingress *Sukuk* Berhad and *Murabahah* ICP/IMTN issued by Nam Fatt Corporation Berhad will be discussed in the context of Malaysian capital market. Sources of data include observation, documents and texts (i.e. archival research), specifically from the SC, RAM Ratings and MARC, and authors' analysis on the subject matter.

Written data sources include published and unpublished documents, company reports, reports, newspaper articles and others. The information on defaulted and solvent firms is collected from Malaysia Rating Corporation Berhad's (MARC) annual or monthly ratings of middle to short-term corporate *sukuk* issued by companies from 2000 until 2010, which later turn out to be defaulted. The financial information of these companies over the period is obtained from the MARC and Rating Agency Malaysia (RAM) databases, as well as Securities Commission's website.

4. Overview of *Sukuk* in Malaysia

4.1 *Sukuk* development

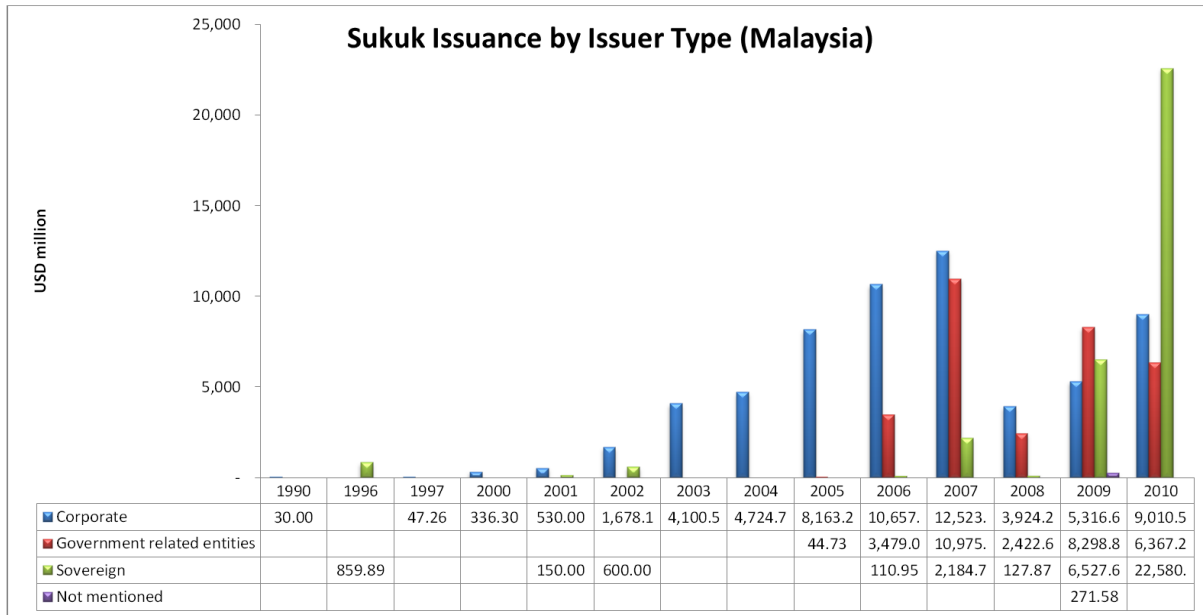
Malaysia has emerged as leader in *sukuk* market since the first corporate *sukuk* issuance in 1990 by Shell MDS Sdn. Bhd. This is due to the consistent growth in the issuance of *sukuk*, increase in the level of knowledge and numbers of expertise amongst market players and progressive development of the Malaysian legal framework. This situation makes Malaysia the world's largest *sukuk* issuer with more than 60% of outstanding global *sukuk* (as at end of 2009). From total *sukuk* issued globally, 66.8% with a value of USD 67,872 million were issued in Malaysian market, as illustrated in Table 1. As at end June 2010, local currency *sukuk* market stood at a whopping USD76.4 billion or 35.5% of total bond market outstanding. This is attributable to various factors including well-executed policies, facilitative regulatory environment, increasing numbers and sophistication of intermediaries that continue to push the frontiers in terms of product innovation as well as the existence of a complete, matured and well established Islamic financial system.

Table 1: Regional Break-up of the Domestic *Sukuk* Market

Country	Volume (US\$ millions)	No. of Issues	% of Total Value
<i>Asia</i>			
Malaysia	67,872	792	66.8
Indonesia	1,923	48	1.9
Pakistan	1,657	31	1.6
Brunei	740	13	0.7
Singapore	99	2	0.1
<i>GCC</i>			
Saudi Arabia	7,665	10	7.5
UAE	7,151	10	7.0
Bahrain	1,508	77	1.5
Qatar	137	1	0.1
<i>US, Europe and Africa</i>			
US	167	1	0.2
Germany	123	1	0.1
Gambia	0.388	1	0.0
Sudan	12,614	20	12.4
Total	101,656	1,007	100.0

Source: International Islamic Financial Market-IIFM (2009)

Malaysia's Islamic capital market continues to show vibrant growth as can be seen from the ever-increasing size and diversity of *sukuk* offered. This is attributable to various factors including well-executed policies, facilitative regulatory environment, increasing numbers and sophistication of intermediaries that continue to push the frontiers in terms of product innovation as well as the existence of a complete, matured and well-established Islamic financial system. Figure 3 depicts total outstanding *sukuk* issued by public and private sectors from 1990 to 2010, dominated by corporate issuers for the period of 1997-2008, government related entities in 2009, and sovereign in 2010.



Source: IFIS & RAM Ratings (2010).

Figure 3: Sukuk Issuance by Type of Issuer in Malaysia (USD mil.)

The corporate debt securities and *sukuk* market had withstood severe stress during the 1997/1998 Asian financial crisis, and again during the economic slowdown in 2001 following the collapse of the information technology (IT) bubble in the advanced economies. Notably, corporations that have funded their long-term capital investments or business expansion projects with long-term debt securities and *sukuk* had escaped the negative effects of credit crunches, interest rate spikes and exchange rate depreciation. This had contributed to the stable performance of the debt securities and *sukuk*.

Besides avoiding the risks of currency, maturity and asset-liability mismatches, only debt securities and *sukuk* that carry investment-grade ratings from the domestic rating agencies had been allowed to be issued in the Malaysian market during the early years. Mandatory rating, together with the requirement for investment-grade ratings (removed as the market matured), had helped boost investor confidence during the domestic debt securities and *sukuk* market's nascent phase. The market integrity and confidence established during the formative years, which had led to successful redemptions of debt securities and *sukuk* upon maturity, had in turn stimulated confidence in and acceptance of long-tenured corporate debt securities and *sukuk*, some of which stretch for over 30 years.

4.2 Evidence of default in capital market

The debt securities and *sukuk* issued in the Malaysian market are mostly rated from AAA to BBB, although most issues tend to cluster around the AA category. Table 2 explains total corporate bond (inclusive of *sukuk*) defaults in Malaysia, from 1997 to 2009. Note that there had been no default prior to 1997. By referring to the default rate by no. of issuers (column 5), there is a significant correlation between no. of issuers and issues (positive value of %). The overall defaults involve quite a huge amount of money (RM12.9 billion).

Table 2: Total defaults (1997 – 2009)

Year	Total defaulted			Default rate (by no. of issuers)	Defaults with bank guarantees		No. of issuer defaults ex-bank guarantee	Adjusted default rate (by no. of issuers)
	No. of issuers	No. of issues	Amount of rated debt (RM million)	(%)	No. of issuers	No. of issues		(%)
1997	1	1	30	0.6	1	1	-	-
1998	16	20	3,820	8.8	11	12	5	2.8
1999	4	5	1,850	2.5	3	3	1	0.6
2000	6	12	1,875	3.6	4	9	2	1.2
2001	4	12	2,757	2.3	-	-	4	2.3
2002	-	-	-	-	-	-	-	-
2003	3	3	225	1.9	-	-	3	1.9
2004	2	2	98	1.1	1	1	1	0.6
2005	6	6	1,182	3.3	1	1	5	2.8
2006	-	-	-	-	-	-	-	-
2007	2	2	366	1.0	-	-	2	1.0
2008	2	4	300	1.1	-	-	2	1.1
2009	3	5	394	1.6	1	1	2	1.1
Total	49	70	12,896	1.9	21	27	25	1.1

Note: No default prior to 1997.

Source: RAM Ratings (2010)

Thus, it is interesting and important to investigate the issue of defaults, so that the implication of *sukuk* defaults on the Malaysian capital market could be minimized in future.

5. Analysis of *Sukuk* defaults in Malaysia

Standing true to Islamic principles, *sukuk* are perceived to be ethically protected from turning bad. However, when *sukuk* defaults had been scrutinised by the practitioners and academicians, concerns had been raised on the reliability of their structures and *Shariah* supervision. This has created the perception that *sukuk* may not be any safer than conventional bonds in terms of investor protection and the treatment of defaults. This situation will also tarnish the reputation of Malaysian capital market since Malaysia has been recognized as the hub for Islamic capital market in the world. Unlike the high-profile default cases in the Middle East, Malaysia's *sukuk* defaults have received less criticism and scrutiny from global industry players. The reasons are due to our robust supervisory structure, established governance and disclosure standards, and the highly developed legal framework and court system which provide the necessary protection and comfort to investors. It is very interesting and vital to investigate the defaults issue and its implication, especially for the *sukuk* since there are a lot of issues and debates in terms of their structure and concept, particularly from the *shariah* perspectives (Rosly & Sanusi, 1999; Al-Amine, 2001 & RAM Ratings, 2010).

Despite the wide variance in ratings, the default rate for Malaysian *sukuk* in 2009 was relatively low at 0.46 per cent (SC, 2010). For the period of 1997 – 2010, there are altogether 24 cases of *sukuk* default, as illustrated in Table 3. Of all cases, they were mainly structured based on *murabahah* and *BBA* contracts – 12 on *murabahah*, 11 *BBA*, and only one on *ijarah*. *BBA* had been a popular *shariah* contract for *sukuk* when the Islamic capital market was first developed in Malaysia. Due to some of the controversial elements embedded in the structure, however, it is

only accepted in the Malaysian market. Under the *BBA* structure, eligible *sukuk* investors will first purchase (from the issuer) the underlying assets at an agreed purchase price. The assets must be certified as *Shariah*-compliant and of sufficient value, as per the pricing guidelines of the SC's *Shariah* Advisory Council. The assets will subsequently be sold back to the issuer at cost plus a profit on deferred payment. Therefore, *BBA sukuk* contract will be used to securitize *shariah*-compliant assets and it adds value to the debt facility, in terms of credibility and liquidity.

Table 3: Total Defaulted *Sukuk* (1997 – 2010)

Issuance Date	Rating Agency	Initial Rating [#]	Issuer	Type of Sukuk	Amount (RM mil)	Date of Default	Final Rating
17 Apr 1997	RAM Ratings	A2	Hualon Corporation (M) Sdn Bhd	<i>Bai' Bithaman Ajil</i> Islamic Debt Securities (BaIDS)	150	21 Nov 2003	D
25 Jan 1999	RAM Ratings	BBB3	Johor Corporation	<i>Murabahah</i> Islamic Debt Securities	500	27 June 2002	D
21 Sept 2000*	MARC	A _{ID} /MARC-2 _{ID}	Europlus Corporation Sdn Bhd	BaIDS	250	10 Mar 2006	D _{ID}
11 Dec 2000	RAM Ratings	BBB3	Moccis Trading Sdn Bhd	BaIDS	50	3 June 2003	D
22 Feb 2001*	MARC	A _{ID}	Maxisegar Sdn Bhd	BaIDS	300	10 Mar 2006	D _{ID}
24 July 2003	MARC	MARC-3 _{ID}	Perspektif Perkasa Sdn Bhd	<i>Murabahah</i> Underwritten Notes Issuance Facility (MUNIF)	188	10 Mar 2006	D _{ID}
19 Sept 2003	MARC	MARC-3 _{ID}	Stenta Films (M) Sdn Bhd	MUNIF	90	20 Sept 2007	D _{ID}
28 Nov 2003	MARC	AA _{ID}	Malaysian Merchant Marine Berhad	BaIDS	120	2 Apr 2010	D _{ID}
30 Dec 2003	MARC	AID/MARC-2 _{ID}	Evermaster Berhad	BaIDS & <i>Murabahah</i> Multi-Option Notes Issuance Facility	50 & 40	31 Dec 2008	D _{ID}
1 Apr 2004	MARC	A+ _{ID} /MARC-1 _{ID}	Pesaka Astana (M) Sdn Bhd	BaIDS	200	30 Sept 2005	D _{ID}
9 July 2004	MARC	A+ _{ID}	Ingress Sukuk Berhad	<i>Sukuk Ijarah</i>	160	13 July 2009	D _{IS}
7 Oct 2004	MARC	AID/MARC-2 _{ID}	Oilcorp Berhad	<i>Murabahah</i> IMTN/MUNIF	70	7 Oct 2009	D _{ID}
19 Oct 2004	RAM Ratings	A3/P2	BSA International Berhad	<i>Murabahah</i> CP/MTN	150	28 May 2008	D

4 Nov 2004*	MARC	AID/ MARC- 2 _{ID}	Jana Niaga Sdn Bhd	MUNIF	100	15 Nov 2007	D _{ID}
12 Nov 2004	RAM Ratings	A2/ P2	The Royal Mint of Malaysia Sdn Bhd	<i>Murabahah</i> Multi-Option Notes Issuance Facility	55	8 June 2007	D
15 Dec 2004	MARC	AA _{ID}	PSSB Ship Management Sdn Bhd	BaIDS	40	15 Dec 2009	D _{ID}
28 Jan 2005	MARC	A _{ID}	Tracoma Holdings Berhad	BaIDS	100	29 Jan 2009	D _{ID}
8 Mar 2005	MARC	MARC- 2 _{ID}	M-Trex Corporation Sdn Bhd	<i>Murabahah</i> ICP	60	21 May 2009	D _{ID}
29 Apr 2005	RAM Ratings	A1(s)/ P1(s)	Oxbridge Height Sdn Bhd	<i>Murabahah</i> IMTN/ MUNIF	104/ 50	6 Apr 2009	D
26 Sept 2005	MARC	A _{ID}	Englotechs Holding Bhd	<i>Murabahah</i> MTN	50	27 Mar 2009	D _{ID}
28 Oct 2005	RAM Ratings	A2	Memory Tech Sdn Bhd	BaIDS	320	7 June 2007	D
31 Jan 2006	MARC	A+ _{ID} / MARC- 1 _{ID}	Nam Fatt Corporation Berhad	<i>Murabahah</i> ICP/ IMTN	250	6 Apr 2010	D _{ID}
13 Apr 2007	MARC	MARC- 1 _{ID}	Straight A's Portfolio Sdn Bhd	MUNIF	200	11 Dec 2009	D _{ID}
17 May 2007	MARC	A+ _{ID}	Malaysian International Tuna Port Sdn Bhd	BaIDS	240	18 Nov 2009	D _{ID}

Note: #For details of rating definition used by MARC & RAM Ratings, refer to Appendix 1 & 2.

* Date of issuance is based from press releases on rating agencies' website/internal database.

Sources: RAM Ratings (2010)

Based on the RAM Rating's data and the statistics provided by SC, the first defaulted *sukuk* in Malaysian capital market is *Murabahah* Islamic Debt Securities issued by Johor Corporation (JCorp), a market-driven Johor State Government-linked Corporation. The corporation is one of Malaysia's leading business conglomerates, comprising more than 280 member companies. As a public enterprise entity, JCorp plays a major role to foster economic growth in the state particularly in several high potential economic sectors including agro-business, industrial development, property and others. This *sukuk* was issued in January 1999 and defaulted after three years in June 2002. This is the first case of defaulted *sukuk* in Malaysia and the largest amount of defaulted *sukuk* in the history of Malaysian capital market so far. There is limited studies and discussion on this defaulted *sukuk* due to the status of this corporation as the state government-linked corporation. As per today, JCorp continue to dedicate itself in

creating new opportunities not only for its own corporate growth and expansion but also towards contributing country's economic enhancement.

On the other hand, the latest Malaysian defaulted *sukuk* is a *Murabahah* ICP/IMTN that was issued by Nam Fatt Corporation Berhad. Nam Fatt is a multinational group with over 1,000 personnel employed in thirty-one subsidiaries and four associated companies. This company has international presence in six countries through their worldwide offices and have gone beyond Malaysian shores, to Singapore, Brunei, Indonesia, Thailand, Vietnam, China, Japan, Turkmenistan, Sudan and the Middle East. This 250 million Malaysian Ringgit *sukuk* used the Islamic financing principle of *Murabahah*, a secured financing of an asset on a deferred payment basis with a pre-agreed payment period. Figure 4 shows the timeline of Nam Fatt *sukuk* since it was issued until defaulted on April 2010. Full information on the rating trend starting from initial rating to the final rating in the event of default could be found in Appendix 3.

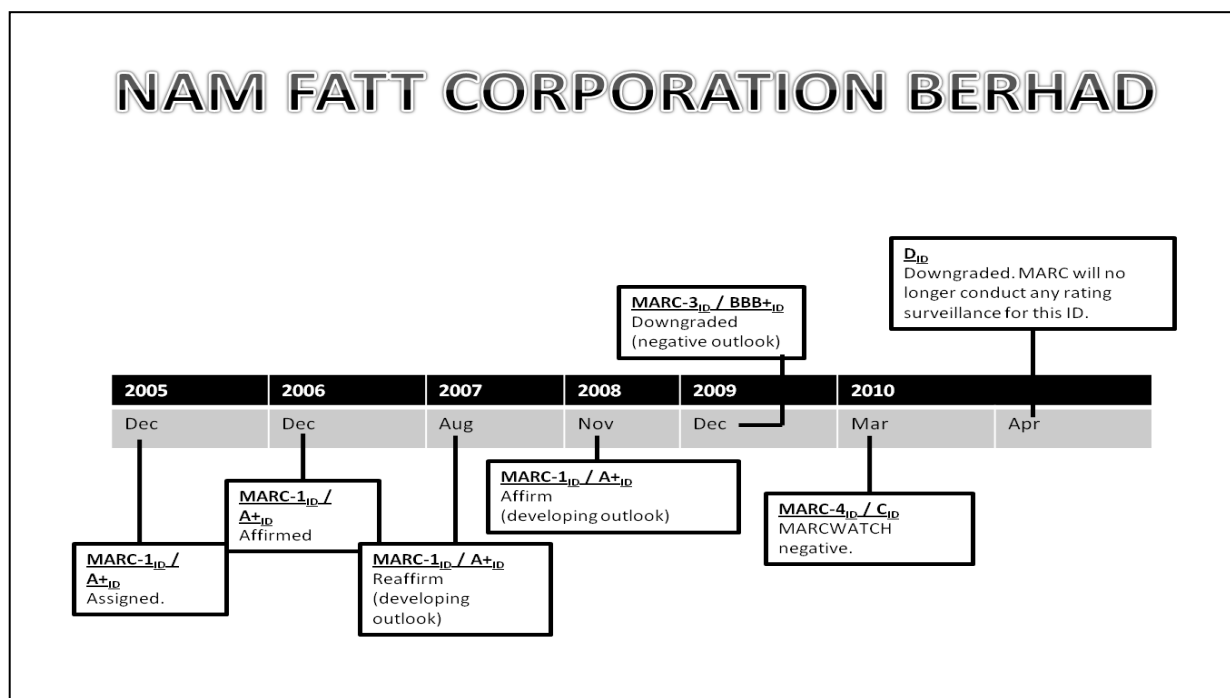


Figure 4: Nam Fatt Corporation Rating Timeline

Besides Nam Fatt, Tracoma is another case of *sukuk* defaults in the Malaysian capital market. Tracoma's vast experience and good track record as one of the leading local manufacturers of automotive components, and its commendable financials was reflected in November 2004, when MARC assigned an initial rating of A_{ID} to the issue. In October 2006, premised on Tracoma's delay in depositing the monthly amount in the PSA required for the upcoming profit payments due in January 2007, MARC placed Tracoma's RM100 million BaIDS on a negative outlook. Due to Tracoma's tight liquidity position and limited financial flexibility, exacerbated by its weaker than expected cash flow, a couple of downgrades had been instituted during the annual rating reviews on the BaIDS. In late January 2009, due to Tracoma's

failure to redeem its first RM50 million series based on the original scheduled maturity date of 28 January 2009, as confirmed by the trustee, MARC downgraded the rating of the BaIDS to D_{ID}. The missed payment had been treated as an indication that the company was facing financial distress. On 2nd November 2009, Tracoma's proposed RM100 million restructured *Bai' Bithaman Ajil* Debt Securities was issued in response to Tracoma's debt restructuring plan. Based on this latest development, MARC has withdrawn its D rating and assigned C_{ID} rating on the BaIDS. Since the restructuring plan, Tracoma has proposed further changes to the structure of BaIDS, which have yet to be finalised. Finally, in July 2010, MARC has withdrawn its C_{ID} rating on Tracoma proposed BaIDS and reinstated its D_{ID} rating on the Tracoma's defaulted BaIDS. Figure 5 shows the timeline of Tracoma *sukuk* since it was issued until defaulted on July 2010.

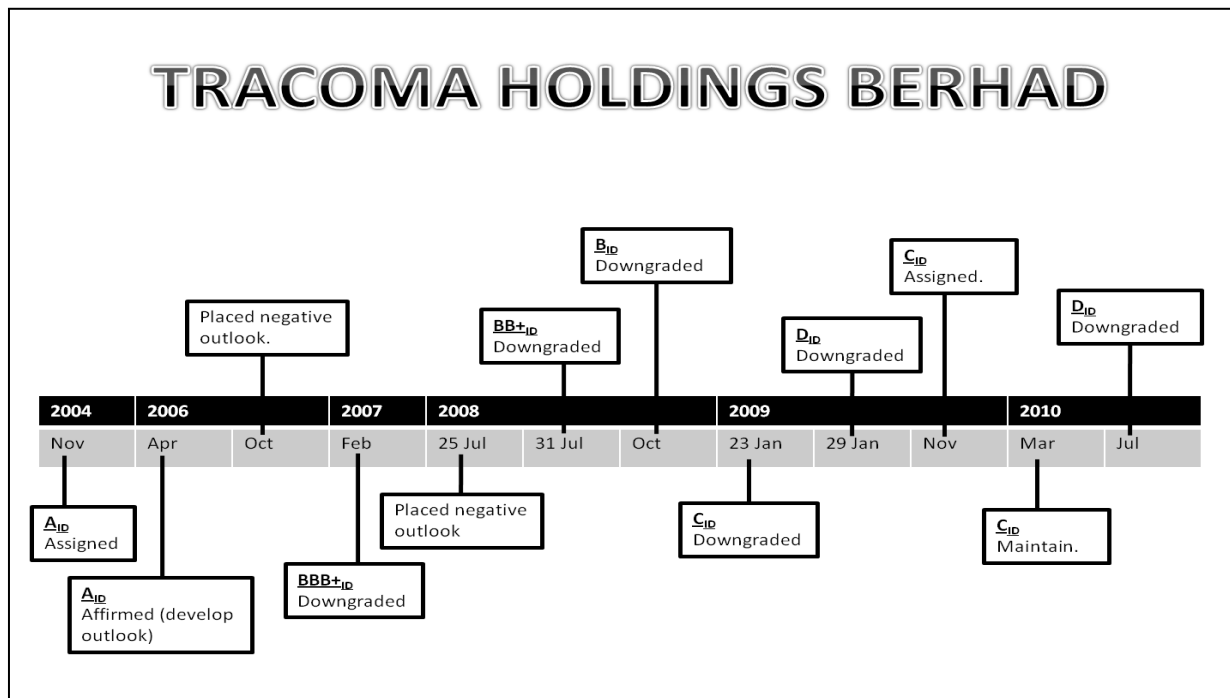


Figure 5: Tracoma Holding Berhad Rating Timeline

MARC has taken the decision to discontinue analytical coverage on the BaIDS until the conclusion of Tracoma's debt restructuring. The rating agency will not be performing ongoing surveillance on the BaIDS with immediate effect. By this time, there is no news on the restructuring plan and MARC is still waiting for any restructuring progress confirmation by the company.

Besides JCorp, Nam Fatt and Tracoma, Ingress *sukuk* is another case of *sukuk* defaults in Malaysia. Since this *sukuk* was the only defaulted *sukuk* that structured based on *ijarah* contract, it was a hot topic for the discussion among the market players and academia. As per the structure in Figure 6, the *sukuk* holders possess undivided proportionate beneficial ownership of the assets and the rights, titles, interests and benefits under all the transaction documents. In addition, a

purchase and sale undertaking is exercisable by both Ingress and ISB for the redemption of the *sukuk* upon the maturity of the issuance, or upon the occurrence of a dissolution event or an event of default vis-à-vis repaying any outstanding balance.

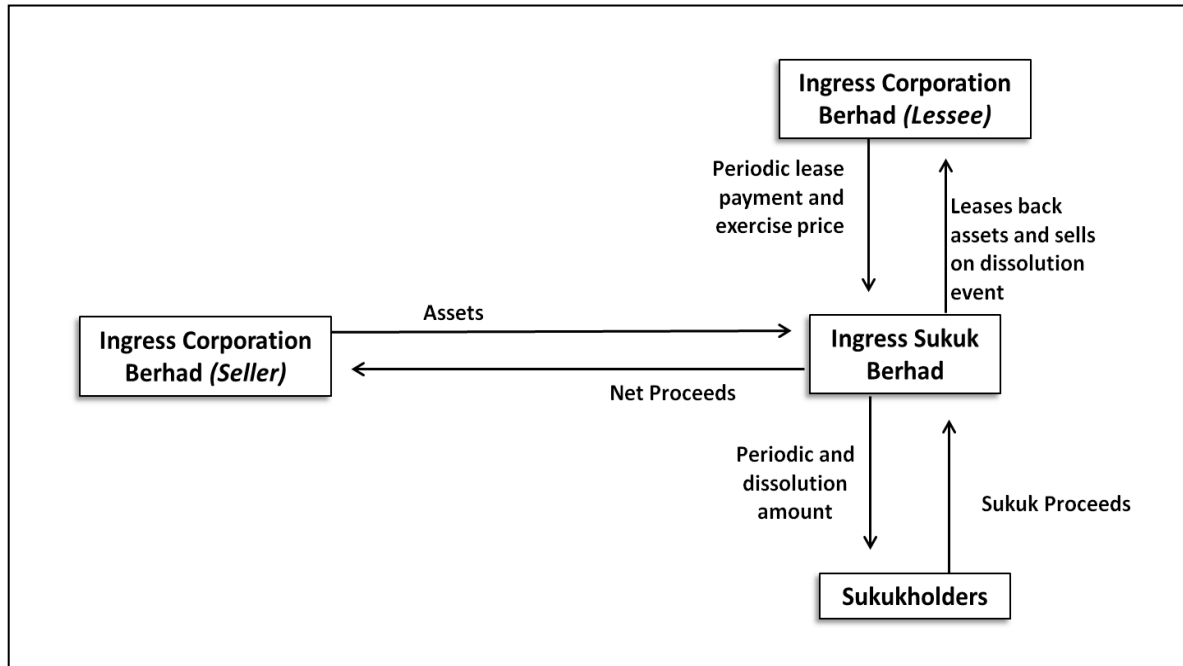


Figure 6: Sukuk Ijarah Transaction Structure

Referring to Figure 7, it shows that on 8th June 2004, the rating of A+_{ID} has been assigned by MARC that reflects Ingress' track record as one of the leading local automotive component manufacturers with a diversified customer and geographical distribution. The rating has been reaffirmed for a few times before being downgraded to A_{IS} on 28th December 2007. The downgraded rating reflects Ingress deteriorating profitability and the breach of its debt-to-equity covenant, resulting from additional debt assumed to fund its substantial capital expenditure in respect of its Thailand operations. On 25th February 2009, MARC has downgraded its rating to A-_{IS} from A_{IS} due to the deteriorating liquidity position and declining profitability of Ingress and followed by a few downgrades until MARC has downgraded its rating to C_{IS} from BB-_{IS} on 6th July 2009 due to ISB's decision to postpone RM45.0 million of the RM50.0 million upcoming first tranche *sukuk* payment due on July 9, 2009 for six months. Finally, the *sukuk* has been downgraded to D_{IS} on 13th July 2009 reflects to ISB's failure to meet its first tranche *sukuk* payment of RM50 million in full, based on the original scheduled maturity on July 9, 2009.

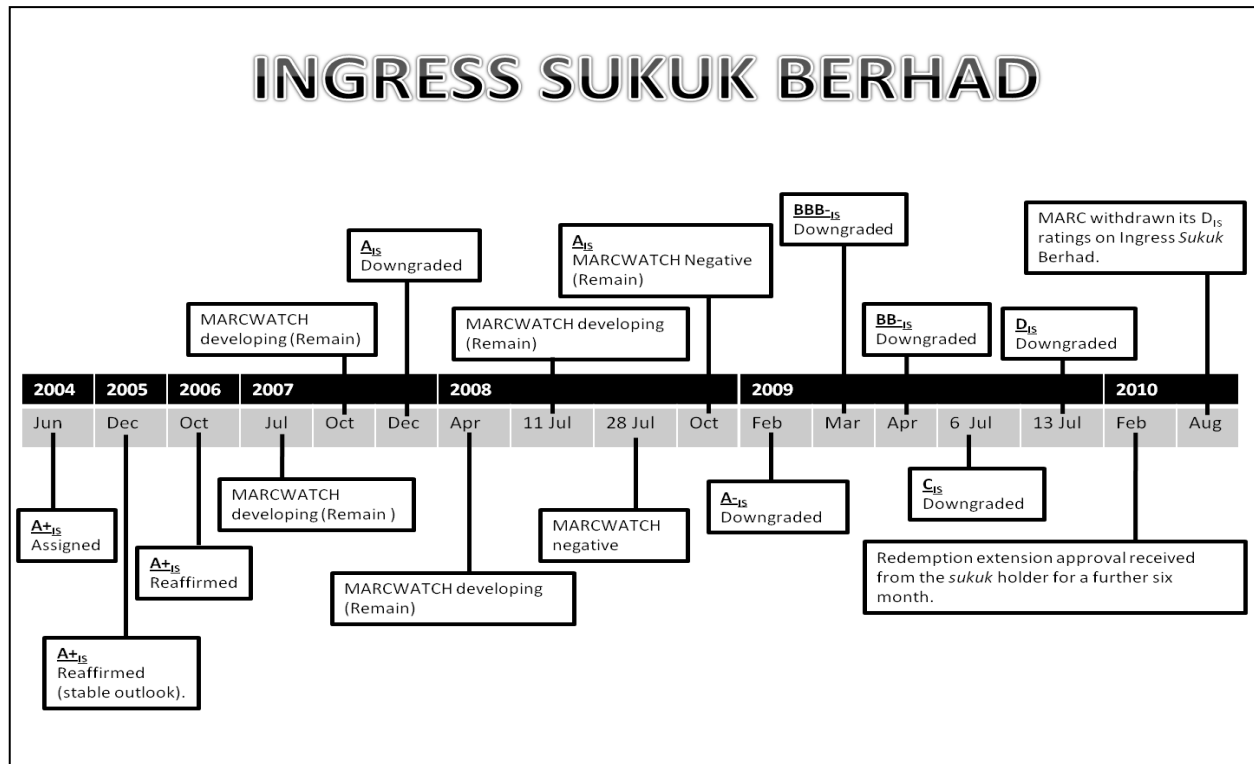


Figure 7: Ingress *Sukuk* Berhad Rating Timeline

Finally, MARC has withdrawn its D_{IS} ratings on Ingress Sukuk Berhad's (ISB) RM160 million *Sukuk Al Ijarah* Programme with immediate effect following the full redemption of the *sukuk* and cancellation of the programme on July 2, 2010.

Based on the defaulted *sukuk* cases discussed, even though *sukuk* default may not pose significant threat to the capital market, however, it does have an impact on the overall reputation of Malaysia as the international hub for Islamic finance, where investors and other countries worldwide monitor the development of this particular capital market, the *sukuk* issuance. For a corporation that issues the *sukuk* in order to raise capital, the failure to make a timely payment as agreed in the contract raises the probability of default on that particular *sukuk*. If it fails to pay on time and finally declares a default, the rights of the firm's shareholder are affected as well. Therefore, it is crucial that the *sukuk* issuer takes immediate action if it foresees a possibility of defaulting. In this case, the issuer could opt for a refinancing or a restructuring. There are cases where defaults on *sukuk* had almost been declared, but the issuers took actions before the defaults were declared, and the *sukuk* was either restructured or refinanced. As evidence, Talam Corporation had already restructured its *sukuk* before declaring a default, whilst in the case of Ingress; the firm restructured its *sukuk* only after having declared a default.

Another major issue in *sukuk* default is the investors' right and protection. Since many perceive that *sukuk* should be more secured rather than the conventional bonds, the default should be seen as something to be avoided from the perspective of investment attraction. In this

case, since *sukuk* has a different structure compared to conventional bond, the protection actually depends on the structure of the contract; i.e investors' protection in *ijarah sukuk* structure might be different, as compared to *musharakah sukuk* structure. That is why it is very interesting to investigate and explore defaulted *sukuk* contracts in Malaysia since their structures are totally attractive from the financial and investment perspectives. This may be due to the different school of thought in Malaysia, opposed to the Middle-East countries.

From the legal point of view, the discussions and debates in the Islamic finance world show that any disputes in the contract may lead to *shariah* non-compliance risk. Like the Middle East countries, Malaysia has also had its fair share of *sukuk* defaults, albeit a lower issuance value. Nonetheless, what protected Malaysia from the negative impact are the tight regulations and laws that bind the *sukuk* market. Both *sukuk* and conventional bonds are governed by similar standards, guidelines and laws that issuers have to abide by. *Sukuk* are therefore considered as a financial obligation, whereby the investors are recognised as creditors and rank equally with other conventional creditors. This provides some level of comfort to the investors, knowing that they are adequately protected in any unfavourable event.

6. Conclusion

In the current environment, the demand for *sukuk* significantly exceeds the supply. The phenomenal demand has been spurred by the high levels of surplus savings and reserves in Asia and Gulf regions. The *sukuk* market brings with it many benefits to both issuers and investors. Issuers can benefit from the huge increase in liquidity in the Islamic world, and can tap on these new sources of funds. An increased number of multilateral agencies are issuing *sukuk* to finance development projects. In addition, both government agencies and the corporate sector have considered the *sukuk* market as an attractive source of financing.

What are the wider impacts for the *sukuk* defaults in the Malaysian capital market? *Sukuk* default in Malaysia may not pose significant threat to the local capital market; however it does have an impact on the overall reputation of Malaysia as the hub for global Islamic finance. In the Middle East, investor sentiment for *sukuk* issuances has been severely damaged when the Nakheel initial debt standstill and this might have halted strong rebound of the *sukuk* market in the wake of continued uncertainty about investor protection.

Generally, there is a concern about whether *shariah* compliance might hamper an orderly dispute resolution under conventional law and about the legal enforceability of asset claims under the AAOIFI recommendations on *sukuk* structures. Considerable heterogeneity of scholastic opinion continues to hamper the creation of a consistent regulatory framework and corporate governance principles. Islamic jurisprudence is neither definite nor bound by precedent in absence of unified principles on which *shariah* scholars decide on compliance of new products. Fragmented opinions of *shariah* boards have inhibited universal recognition and enforceability of rulings, which has raised the issue of “non-*shariah* compliance risk”.

Malaysia conforms to consistent and clear investors' protection whereby the investors are well aware of their position and options. Whilst the investors' protection is very much intact and market-tested, the legal and recovery process is also in order. Apart from being well-regulated by various standards and guidelines, Malaysia is also the only country that makes it compulsory for all tradable corporate debt securities to be rated - to enhance investors' confidence and to assist in the investment decision-making process. Another distinguishing factor for the Malaysian *sukuk* market is the establishment of a centralised, national level *Shariah* supervisory board, which

ensures that every *sukuk* issued in Malaysia, is in full compliance with the *Shariah*. All these factors provide sufficient protection to investors in the *sukuk* and conventional bond markets.

The tight rules and regulations that bind the *sukuk* market have protected Malaysian capital market from the negative perception. Issuers have to abide by similar standards, guidelines and laws that govern both *sukuk* and conventional bonds. *Sukuk* are also considered as financial obligations since the *sukuk* investors are recognized as creditors and rank equally with other conventional creditors. Knowing that they are adequately protected in any unfavourable event, this provides some level of comfort to investors. Besides, the 10th Malaysia Plan which spurs numerous proposals for the construction, facilities and utilities projects, makes *sukuk* as one of the alternatives for the project financing.

End Notes:

¹ AAOIFI Shari'ah Standard No. 17 (Investment Sukuk) as adopted on May 8, 2003.

² An Islamic religious ruling, a scholarly opinion on a matter of Islamic law.

³ A contract made between two parties to finance a business venture. The parties are a *rabb al-mal* or an investor who solely provides the capital and a *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. If the business is a loss, it will be borne solely by the provider of the capital.

⁴ A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind. Any profit derived from the venture is distributed based on a pre-agreed profit sharing ratio and a loss is shared on the basis of capital contribution.

⁵ A contract made between two parties to finance a business venture. The parties are *rabb al-mal* or an investor who solely provides the capital and *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. If the business is a loss, it will be borne solely by the provider of the capital.

⁶ A *manfaah* (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to a client at an agreed rental fee and pre-determined lease period upon the *'aqd* (contract). The ownership of the leased equipment remains in the hands of a lessor.

⁷ A contract referring to the sale and purchase transaction for the financing of an asset on a deferred and installment basis with a pre-agreed payment period. The sale price includes a profit margin.

⁸ A contract whereby payment is made in cash at point of contract but delivery of asset purchased is deferred to a pre-determined date.

⁹ A purchase order contract of assets whereby a buyer places an order to purchase an asset to be delivered in the future. The buyer requires the seller or a contractor to construct the asset and deliver in the future according to the specifications given in the sale and purchase contract. Both parties decide on the sale and purchase prices and the settlement can be delayed or arranged based on a schedule of work completed.

¹⁰ There are two licensed CRAs in Malaysia which provide independent opinions on the credit risks and potential default risks of specific issuers. The first rating agency, RAM Rating Services Berhad (then, Rating Agency Malaysia Berhad (RAM), was established in November 1990; and the second is Malaysian Rating Corporation Berhad (MARC) was incorporated in October 1995.

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Appendix 1

MARC's Rating Symbols and Definitions

Islamic Capital Market Instrument Ratings

Long Term Ratings

MARC's Long-Term Ratings are assigned to Islamic capital market instruments with maturities of more than one year. These ratings specifically assess the likelihood of timely payment of the instrument issued under the various Islamic financing contract(s).

Investment Grade	Description
AAA _{ID}	Extremely strong ability to make payment on the instrument issued under the Islamic financing contract(s).
AA _{ID}	Very strong ability to make payment on the instrument issued under the Islamic financing contract(s). Risk is slight with degree of certainty for timely payment marginally lower than for instruments accorded the highest rating.
A _{ID}	Strong ability to make payment on the instrument issued under the Islamic financing contract(s). However, risks are greater in periods of business and economic stress than for instruments with higher ratings.
BBB _{ID}	Adequate ability to make payment on the instrument issued under the Islamic financing contract(s). Vulnerable to moderately adverse developments, both internal and external.

Non-investment Grade	Description
BB _{ID}	Uncertainties exist that could affect the ability of the issuer to make payment on the instrument issued under the Islamic financing contract(s).
B _{ID}	Significant uncertainty exists as to timely payment on the instrument issued under the Islamic financing contract(s). Slight adverse developments could impair issuer's ability to fulfill such obligation.
C _{ID}	Possesses a substantial risk of default, with little capacity to address further negative changes in financial circumstances.
D _{ID}	Failed to make scheduled payment on the instrument issued under the Islamic financing contract(s).

Notes : Long-Term Ratings from AA to B may be modified by the addition of a plus (+) or minus (-) suffix to show relative standing within the major rating categories. Bank-guaranteed issues will carry a suffix (bg), corporate-guaranteed issues, a (cg), issues guaranteed by a financial guarantee insurer (FGI), an (fg), and all other supports, an (s) when such guarantees or supports give favourable effect to the assigned rating.

Short-Term Ratings

MARC's Short-Term Ratings are assigned to Islamic capital market instruments with original maturities of one year or less, and are intended to assess the likelihood of timely payment of the instrument issued under the various Islamic financing contract(s).

Investment Grade	Description
MARC-1 _{ID}	Extremely strong capacity to make timely payment on the instrument issued under the Islamic financing contract(s).
MARC-2 _{ID}	Strong capacity to make timely payment on the instrument issued under the Islamic financing contract(s). Timeliness of payment is slightly susceptible to adverse changes in operating circumstances and economic conditions.
MARC-3 _{ID}	Adequate capacity to make timely payment on the instrument issued under the Islamic financing contract(s). Moderately adverse changes in operating environment and economic conditions may weaken financial capacity to fulfill such obligation.

Non-investment Grade	Description
MARC-4 _{ID}	Vulnerable to non-payment of instrument issued under the Islamic financing contract(s). Capacity to make payment on the instrument is dependent upon favorable business, financial and economic conditions.
D _{ID}	Failed to make scheduled payment on the instrument issued under the Islamic financing contract(s).

Notes: Short-Term Ratings will also carry a suffix (bg) for bank-guaranteed issues, (cg) for corporate-guaranteed issues, (fg) for FGI-guaranteed issues, and (s) for all other supports when such guarantees or supports give favorable effect to the assigned rating.

Subscript 'ID' for Long-Term and Short-Term Ratings denotes Islamic Private Debt Security.

Rating Outlook

MARC's Rating Outlook assesses the potential direction of the Islamic Capital Market Instrument Rating over the intermediate term (typically over a one to two-year period). The Rating Outlook may either be:

Outlook	Description
POSITIVE	indicates that a rating may be raised;
NEGATIVE	indicates that a rating may be lowered;
STABLE	indicates that a rating is likely to remain unchanged; or
DEVELOPING	indicates that a rating may be raised, lowered or remain unchanged.

Appendix 2

RAM's Rating Symbols and Definitions

Debt-Based Sukuk

An Issue Rating for a debt-based *sukuk* is RAM Ratings' current opinion on the creditworthiness of a particular debt-based *sukuk*. It reflects the overall capacity and willingness of an issuer to meet the financial obligations on a particular debt-based *sukuk* on a full and timely basis, taking into account its expressed terms and conditions. RAM Ratings' *sukuk* ratings are, however, not a measure of compliance with Shariah principles or the role, formation, practices, legitimacy and soundness of the Shariah advisors' recommendations and decisions.

Long-Term Ratings

Grade	Description
AAA	A <i>sukuk</i> rated AAA has superior safety for payment of financial obligations. This is the highest long-term Issue Rating assigned by RAM Ratings to a debt-based <i>sukuk</i> .
AA	A <i>sukuk</i> rated AA has high safety for payment of financial obligations. The issuer is resilient against adverse changes in circumstances, economic conditions and/or operating environments.
A	A <i>sukuk</i> rated A has adequate safety for payment of financial obligations. The issuer is more susceptible to adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories.
BBB	A <i>sukuk</i> rated BBB has moderate safety for payment of financial obligations. The issuer is more likely to be weakened by adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories. This is the lowest investment-grade category.
BB	A <i>sukuk</i> rated BB has low safety for payment of financial obligations. The issuer is highly vulnerable to adverse changes in circumstances, economic conditions and/or operating environments.
B	A <i>sukuk</i> rated B has very low safety for payment of financial obligations. The issuer has a limited ability to withstand adverse changes in circumstances, economic conditions and/or operating environments.
C	A <i>sukuk</i> rated C has a high likelihood of default. The issuer is highly dependent on favourable changes in circumstances, economic conditions and/or operating environments, the lack of which would likely result in it defaulting on a particular <i>sukuk</i> .
D	A <i>sukuk</i> rated D is either currently in default or faces imminent default on its financial obligations, whether or not formally declared. The D rating may also reflect a distressed exchange, the filing of bankruptcy and/or other actions pertaining to the issuer that could jeopardize the payment of a particular <i>sukuk</i> .

Short-Term Ratings

Grade	Description
P1	A <i>sukuk</i> rated P1 has high safety for payment of financial obligations in the short term. This is the highest short-term Issue Rating assigned by RAM Ratings to a debt-based <i>sukuk</i> .
P2	A <i>sukuk</i> rated P2 has adequate safety for payment of financial obligations in the short term. The issuer is more susceptible to the effects of deteriorating circumstances than those in the highest-rated category.
P3	A <i>sukuk</i> rated P3 has moderate safety for payment of financial obligations in the short term. The issuer is more likely to be weakened by the effects of deteriorating circumstances than those in higher-rated categories. This is the lowest investment-grade category.
NP	A <i>sukuk</i> rated NP has doubtful safety for payment of financial obligations in the short term. The issuer faces major uncertainties that could compromise its capacity for payment of a particular <i>sukuk</i> .
D	A <i>sukuk</i> rated D is either currently in default or faces imminent default on its financial obligations, whether or not formally declared. The D rating may also reflect a distressed exchange, the filing of bankruptcy and/or other actions pertaining to the issuer that could jeopardise the payment of a particular <i>sukuk</i> .

For long-term ratings, RAM Ratings applies subscripts 1, 2 or 3 in each rating category from AA to C. The subscript 1 indicates that the issue ranks at the higher end of its generic rating category; the subscript 2 indicates a mid-ranking; and the subscript 3 indicates that the issue ranks at the lower end of its generic rating category. In addition, RAM Ratings applies the suffixes (bg) or (s) to ratings which have been enhanced by a bank guarantee or other supports, respectively.

Partnership-Based Sukuk

An Issue Rating for a partnership-based *sukuk* is RAM Ratings' current opinion on the creditworthiness of a particular partnership-based *sukuk*. It reflects the overall capacity and willingness of an issuer to meet the payment of capital and expected returns on a full and timely basis, taking into account the expressed terms and conditions of the investment contract. RAM Ratings' *sukuk* ratings are, however, not a measure of compliance with *shariah* principles or the role, formation, practices, legitimacy and soundness of the *shariah* advisors' recommendations and decisions.

Long-Term Ratings

Grade	Description
AAA	A <i>sukuk</i> rated AAA has superior safety for payment of capital and expected returns. This is the highest long-term Issue Rating assigned by RAM Ratings to a partnership-based <i>sukuk</i> .
AA	A <i>sukuk</i> rated AA has high safety for payment of capital and expected returns. The issuer is resilient against adverse changes in circumstances, economic conditions and/or operating environments.
A	A <i>sukuk</i> rated A has adequate safety for payment of capital and expected returns. The issuer is more susceptible to adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories.
BBB	A <i>sukuk</i> rated BBB has moderate safety for payment of capital and expected returns. The issuer is more likely to be weakened by adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories. This is the lowest investment-grade category.
BB	A <i>sukuk</i> rated BB has low safety for payment of capital and expected returns. The issuer is highly vulnerable to adverse changes in circumstances, economic conditions and/or operating environments.
B	A <i>sukuk</i> rated B has very low safety for payment of capital and expected returns. The issuer has a limited ability to withstand adverse changes in circumstances, economic conditions and/or operating environments.
C	A <i>sukuk</i> rated C has a high likelihood of not meeting the payment of capital and expected returns. The issuer is highly dependent on favourable changes in circumstances, economic conditions and/or operating environments, the lack of which would likely result in it not fulfilling the terms of the investment contract.
D	A <i>sukuk</i> rated D is either currently not meeting or will not meet the payment of capital and expected returns. The D rating may also reflect a distressed exchange, the filing of bankruptcy and/or other actions pertaining to the issuer that could jeopardize the fulfillment of the investment contract's terms.

Short-Term Ratings

Grade	Description
P1	A <i>sukuk</i> rated P1 has high safety for payment of capital and expected returns in the short term. This is the highest short-term Issue Rating assigned by RAM Ratings a partnership-based <i>sukuk</i> .
P2	A <i>sukuk</i> rated P2 has adequate safety for payment of capital and expected returns in the short term. The issuer is more susceptible to the effects of deteriorating circumstances than those in the highest-rated category.
P3	A <i>sukuk</i> rated P3 has moderate safety for payment of capital and expected returns in the short term. The issuer is more likely to be weakened by the effects of deteriorating circumstances than those in higher-rated categories. This is the lowest investment-grade category.
NP	A <i>sukuk</i> rated NP has doubtful safety for payment of capital and expected returns in the short term. The issuer faces major uncertainties that could compromise its capacity for fulfilling the terms of the investment contract.
D	A <i>sukuk</i> rated D is either currently not meeting or will not meet the payment of capital and expected returns. The D rating may also reflect a distressed exchange, the filing of bankruptcy and/or other actions pertaining to the issuer that could jeopardize the fulfillment of the investment contract's terms.

For long-term ratings, RAM Ratings applies subscripts 1, 2 or 3 in each rating category from AA to C. The subscript 1 indicates that the issue ranks at the higher end of its generic rating category; the subscript 2 indicates a mid-ranking; and the subscript 3 indicates that the issue ranks at the lower end of its generic rating category. In addition, RAM Ratings applies the suffixes (bg) or (s) to ratings which have been enhanced by a bank guarantee or other supports, respectively.

Appendix 3
Rating Trend for Defaulted *Sukuk*
a) Ingress Sukuk Berhad

Rating History	Date	Rating	Status	Event
Rating	Jun 8, 2004	A+IS	INITIAL	<ul style="list-style-type: none"> • MARC has assigned a rating of A+IS that reflects Ingress' track record as one of the leading local automotive component manufacturers with a diversified customer and geographical distribution; and above average financial results characterized by its favourable operating profit margin.
Rating	Dec 8, 2005	A+IS	AFFIRMED	<ul style="list-style-type: none"> • The rating affirmation of A+IS on ISB Sukuk Al Ijarah Issuance is underpinned by Ingress track record as one of the leading local automotive component manufacturers with a diversified customer and geographical distribution; and its fairly strong financial profile.
Rating	Oct 12, 2006	A+IS	REAFFIRMED-STA	<ul style="list-style-type: none"> • MARC has affirmed Ingress Sukuk Berhad's (ISB) RM160 million Sukuk Al Ijara Issuance at A+IS with stable outlook; reflecting Ingress track record as one of the leading local automotive component manufacturers with a relatively diversified customer base and geographical distribution, and it's fairly strong financial profile.

MARCWATCH	Jul 31, 2007	A+IS	MARCWATCH-DEV	<ul style="list-style-type: none"> • The MARCWatch placement follows a recent confirmation from CIMB Trustee Berhad that a breach in the Debt to Equity Ratio had occurred based on Ingress' audited accounts for the financial year ended 31 January 2007.
MARCWATCH	Oct 30, 2007	A+IS	MARCWATCH-DEV	<ul style="list-style-type: none"> • Ingress Sukuk Berhad's (Ingress) A+IS rating on its RM160.0 million Sukuk Al Ijara Issuance Programme remains on MARCWatch Developing pending the completion of MARC's annual rating review. • The rating has been placed on MARCWatch Developing since July 30, 2007 as a result of a breach in the Debt to Equity Ratio according to the Ijarah Agreement dated 1 July 2004.
Rating	Dec 28, 2007	AIS	DOWNGRADED (MARCWATCH-UPL)	<ul style="list-style-type: none"> • MARC has lowered its rating from A+IS, and removed it from MARCWatch Developing. • The downgraded rating reflects Ingress deteriorating profitability and the breach of its debt-to-equity covenant, resulting from additional debt assumed to fund its substantial capital expenditure in respect of its Thailand operations.
MARCWATCH	Apr 11, 2008	AIS	MARCWATCH-DEV	<ul style="list-style-type: none"> • MARC has placed rating of AIS on MARCWatch Developing following Ingress' announcement dated April 10, 2008 to Bursa Malaysia in response to a notice by CIMB Trustee Berhad for non-compliance of financial covenants under the Sukuk issuance.

MARCWATCH	Jul 11, 2008	A _{IS}	MARCWATCH-DEV	<ul style="list-style-type: none"> • MARC's A_{IS} rating on Ingress Sukuk remains on MARCWatch Developing following an extension of the remedy period given to Ingress until July 26, 2008, to resolve a breach in certain financial covenants under the Ijarah Agreement.
MARCWATCH	Jul 28, 2008	A _{IS}	MARCWATCH-NEG	<ul style="list-style-type: none"> • MARC has revised its MARCWatch placement from Developing following Ingress' failure to rectify the breach in certain financial covenants under the Ijarah Agreement. • MARC has been informed by Ingress that the remedy period granted by the Sukukholders up to July 26, 2008 has not been further extended and the company has yet to conclude a refinancing scheme in relation to the Sukuk.
MARCWATCH	Oct 30, 2008	A _{IS}	MARCWATCH-NEG	<ul style="list-style-type: none"> • MARC's long-term rating of A_{IS} remains on MARCWatch Negative, where it had been placed on July 28, 2008 following the company's failure to remedy the non-compliance with certain financial covenants of the Sukuk.

Rating	Feb 25, 2009	A-IS	DOWNGRADED- NEG	<ul style="list-style-type: none"> • MARC has downgraded its rating to A-IS from A_{IS}. • The rating remains on MARCWatch Negative where it had first been placed on July 28, 2008. • The downgrade incorporates the deteriorating liquidity position and declining profitability of Ingress and continuing existing non-compliance with certain financial covenants under the Sukuk.
Rating	Mar 31, 2009	BBB-IS	MARCWATCH- NEG	<ul style="list-style-type: none"> • MARC has lowered its rating to BBB-IS from A-IS and maintains the lowered rating on MARCWatch Negative where it had been first placed on July 28, 2008. • The downgrade considers Ingress' insufficient liquidity resources as well as the lack of positive developments with regard to its refinancing initiatives and asset disposals vis-à-vis its upcoming scheduled RM50 million Sukuk redemption in July 9, 2009.

Rating	Apr 10, 2009	BB- _{IS}	DOWNGRADED-NEG	<ul style="list-style-type: none"> • MARC has lowered its rating to BB-_{IS} from BBB-_{IS}. • The lowered rating remains on MARCWatch Negative. • Since MARC's downgrade of ISB's sukuk rating on March 31, 2009, ISB has failed to make a RM25 million payment into the Ijarah Service Rental Account (ISRA) within the required deadline of April 9, 2009. • Therefore, the MARCWatch Negative incorporates the possibility of the rating being further lowered if ISB fails to meet its sinking fund build-up requirement within the 30-day remedy period.
Rating	Jul 6, 2009	C _{IS}	DOWNGRADED	<ul style="list-style-type: none"> • MARC has downgraded its rating to C_{IS} from BB-_{IS}. • The rating remains on MARCWatch Negative. • The rating action is based on ISB's decision to postpone RM45.0 million of the RM50.0 million upcoming first tranche sukuk payment due on July 9, 2009 for six months.
Rating	Jul 13, 2009	D _{IS}	DOWNGRADED	<ul style="list-style-type: none"> • MARC has downgraded its rating to D_{IS} from C_{IS}. • The rating of D_{IS} reflects ISB's failure to meet its first tranche sukuk payment of RM50 million in full based on the original scheduled maturity on July 9, 2009.

Rating	Feb 2, 2010	D _{IS}	UPDATE	<ul style="list-style-type: none"> • MARC has issued this rating update in connection with Ingress pursuant to a confirmation received from its facility agent that approval has been obtained from the sukukholders for a further six-month extension of the redemption date of the first tranche of the sukuk programme to July 9, 2010 from January 9, 2010. • The redemption dates for the second and final tranches of the sukuk remain unchanged at July 9, 2010 and July 8, 2011, respectively. • MARC's rating of D_{IS} on the sukuk remains unchanged and continues to reflect an uncured payment default on its first tranche of the sukuk programme based on its July 9, 2009 original scheduled maturity. • The rating will remain at D_{IS} until the default is cured or the rating is withdrawn upon the completion of parent, Ingress Corporation Berhad's (Ingress), restructuring process.
Current Rating	Aug 13, 2010	D _{IS}	WITHDRAWN- REDEEMED	<ul style="list-style-type: none"> • MARC has withdrawn its D_{IS} ratings following the full redemption of the sukuk and cancellation of the programme on July 2, 2010.

b) Nam Fatt Corporation ICP/IMTN

Rating History	Date	Rating	Status	Event
Rating	Dec 21, 2005	MARC-1 _{ID} /A+ _{ID}	INITIAL	<ul style="list-style-type: none"> • MARC has assigned a rating of MARC-1_{ID} /A+_{ID}. The rating reflect a tight issue structure with pre-determined criteria of contracts. • The structural element of this contract enhances the credit strength of Nam Fatt with good operating track record and improving financial profile.
Rating	Dec 21, 2006	MARC-1 _{ID} /A+ _{ID}	AFFIRMED	<ul style="list-style-type: none"> • The rating affirmation of MARC-1_{ID} /A+_{ID} with stable outlook premised on the tight issue structure governing the facility. • With strict drawdown and restriction type of contract which includes other clearance from MARC the contract will not have negative impact.
Rating	Aug 1, 2007	MARC-1 _{ID} /A+ _{ID}	REAFFIRMED	<ul style="list-style-type: none"> • MARC has affirmed Nam Fatt Corporation Berhad's (Nam Fatt) ratings for its RM250 million Islamic Commercial Paper/Islamic Medium Term Notes Programme (ICP /IMTN) at MARC-1_{ID} /A+_{ID}. • The rating predicted on the facility's tight issue structure confines the utilization of drawdown for specific contracts or projects ensure them with creditworthy counterparties can be financed.

Rating	Nov 24, 2008	MARC-1 _{ID} / A+ _{ID}	AFFIRMED-DEV	<ul style="list-style-type: none"> • MARC has affirmed its rating of MARC-1_{ID} / A+_{ID} on Nam Fatt Corporation Berhad's (Nam Fatt) RM250 million Islamic Commercial Paper/ Islamic Medium Term Notes Programme (ICP/ IMTN). • The affirmed ratings reflect the structural protections afforded to noteholders under the rated facility.
MARCWATCH & Rating	Dec 30, 2009	MARC-3 _{ID} / BBB+ _{ID}	MARCWATCH-NEG & DOWNGRADE	<ul style="list-style-type: none"> • MARC has downgraded its ratings on Nam Fatt Corporation Berhad's (Nam Fatt) RM250 million Islamic Commercial Paper/ Islamic Medium Term Notes Programme (ICP/ IMTN) to MARC-3_{ID} / BBB+_{ID} from MARC-1_{ID} / A+_{ID}, and concurrently placed the ratings on MARCWATCH Negative. • The downgrade reflects significant and severe deterioration in the credit profile of Nam Fatt due to material delays in the progress of certain existing projects and unresolved claims in respect of its Sudan-based Melut Basin contract.

MARCWATCH & Rating	Mar 16, 2010	MARC-4 _{ID} /C _{ID}	DOWNGRADED (MARCWATCH- UPL)	<ul style="list-style-type: none"> • MARC has downgraded its ratings on Nam Fatt Corporation Berhad's (Nam Fatt) RM250 million Islamic Commercial Paper/Islamic Medium Term Notes Programme (ICP/IMTN) to MARC-4_{ID}/C_{ID}. • The rating downgraded reflecting from Nam Fatt's failure to meet its principal and interest payment of about RM13.2 million to Bank Kerjasama Rakyat Malaysia Berhad on March 15, 2010
MARCWATCH & Rating	Apr 6, 2008	D _{ID}	MARCWATCH- DEV	<ul style="list-style-type: none"> • MARC has downgraded its long- and short-term ratings on Nam Fatt Corporation Berhad's (Nam Fatt) RM250 million Islamic Commercial Papers/Islamic Medium Term Notes Programme (ICP/IMTN) as follows: <ul style="list-style-type: none"> • Long-term debt rating to D_{ID} from C_{ID} • Short-term debt rating to D_{ID} from MARC-4_{ID}

c) Tracoma Holding Berhad

Rating History	Date	Rating	Status	Event
Rating	Nov 29, 2004	A _{ID}	INITIAL	<ul style="list-style-type: none"> Tracoma's vast experience and good track record as one of the leading local manufacturers of automotive components, and its commendable financials
Rating	Apr 7, 2006	A _{ID}	AFFIRMED	<ul style="list-style-type: none"> Tracoma Group's proven track record as a Tier-1 local automotive component manufacturer coupled with its on-going expansion plans.
MARCWATCH	Oct 3, 2006	A _{ID}	MARCWATCH-NEG	<ul style="list-style-type: none"> Tracoma's delay to deposit the monthly built up in the PSA
MARCWATCH & Rating	Feb 26, 2007	BBB ⁺ _{ID}	DOWNGRADED (MARCWATCH-UPL)	<ul style="list-style-type: none"> Current negative domestic automotive industry outlook reflecting weak industry fundamentals, have an adverse impact on Tracoma's future operating & financial performance.
MARCWATCH	Jul 25, 2008	BBB ⁺ _{ID}	MARCWATCH-NEG	<ul style="list-style-type: none"> Reflects heightened concerns about Tracoma's ability to make a RM 25 million scheduled payment
MARCWATCH & Rating	Jul 31, 2008	BB ⁺ _{ID}	DOWNGRADED (MARCWATCH-NEG)	<ul style="list-style-type: none"> Company's tight liquidity position and limited financial flexibility
MARCWATCH & Rating	Oct 30, 2008	B _{ID}	DOWNGRADED-NEG (MARCWATCH-UPL)	<ul style="list-style-type: none"> Heightened concerns over Tracoma's ability to redeem its first BaIDS series
Rating	Jan 23, 2009	C _{ID}	DOWNGRADED-NEG	<ul style="list-style-type: none"> No payment made on its first BaIDS series of RM 50 million
Rating	Jan 29, 2009	D _{ID}	DOWNGRADED (WITHDRAWN-DEFAULT)	<ul style="list-style-type: none"> Tracoma's failure to redeem its first BaIDS series of RM 50 million, company is facing financial distress.

Rating	Nov 2, 2009	C _{ID}	RESTRUCTURED	<ul style="list-style-type: none"> Proposed structured, reflects
Rating	Mar 5, 2010	C _{ID}		
Rating	July 15, 2010	D _{ID}	DOWNGRADED	<ul style="list-style-type: none"> The rating agency notes that since the assignment of the preliminary rating to the restructured debt instrument in November 2009, Tracoma has proposed further changes to the structure of the BaIDS, which have yet to be finalised