RATINGS
OF
ISLAMIC FINANCIAL INSTITUTIONS

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Role of Ratings

- Conventional Rating Methodology vs. Methodology for Islamic Financial Institution;
- Banking, Insurance & Capital Market are Three Integral Parts of any Financial System;
- Ratings Provide the Right Checks & Balances in the System; and
- Ratings Fully Appreciate the Nature of Islamic Transactions.

Role of Ratings

- Conventionally, Ratings are Independent Opinions on the Repayment Capacity of the Issuer or an Issue;
- As Custodians of Public Funds, there is a High Requirement for Transparency in the Financial Sector;
- There are Elements other than Riba Required in a Transaction to be Shari'a Complaint – Shari'a Principles Prohibited Transactions that are not free of 'Gharar' or Ambiguity;
- While Acknowledgement of the Investors' Right to Know drives any Financial System, it has a Special Place in an Islamic system;

Types of Liabilities

- Amanah Accounts
  - Non-Remunerative;
  - Not subject to variability in returns;
  - Closest to Conventional Credits and therefore can be Assigned Credit Ratings.

- Profit Sharing Investment Accounts (PSIA)
  - Pay a Return as Compensation for the Possibility of Loss to be Borne by the Investor;
  - Not Liabilities in the Conventional Sense & Investment Account Holders are Not Creditors;
  - Nominal Loss to the Investor may Not Constitute a Contractual Violation;
  - If Loss of Invested Capital is taken as Default, should the Timeliness of that Payment be given the same Importance as in Conventional Ratings;
  - Should the Rating Objective be the Assessment of Ultimate Recovery.

Mutability of PSIA Characteristics

- While Loss on the Investment Portfolio can be Passed to the Investment Account Holders (IAHs), Non-Payment due to Lack of Liquidity can Trigger Default;
- Depositor's Claim to his PSIA, Net of any Portfolio Loss Attributed to it, is Not Inferior to Any Other Obligation of the IFI;
- Shari'a Non-Compliance is yet another Event that can Mutate PSIA into Conventional Credits;
- Liquidity Risks and Operational Risks and their likely Impact on the IFI's Ability to Pay on a Timely Basis are to be Examined Carefully.

Displaced Commercial Risk & Smoothing

- In case an Islamic Bank Passes a loss to its Depositors or Pays Profit Below the Market Rates, this may cause Mass Deposit Withdrawal;
- Creation of Profit Equalization Reserve and the Investment Risk Reserve for Providing Cushion to Depositors and Smoothing Returns, gives Significant Strength to Ratings.
- Can Likelihood of 'Hiba' by Shareholders Provide Comfort to Depositors.

Variance from Conventional Methodologies

- Treating Capital Loss as Default may be Argued as not in Line with the Profit & Loss Based Transactions;
- The Mudarib's Performance in Delivering the Maximum Value to Investors Receive a Higher Degree of Weight than such Considerations Normally do in Conventional Ratings;
- Integrity and Expertise of the Mudarib as an Asset Manager are Looked at More Sensitively as the Investor's Dues are a Function of this Performance;
- Shari'a Compliance Encompassing, but Not Limited to All Principles of Corporate Governance will have a Distinct Bearing on Ratings;

Risks & Modes of Islamic Financing

- Risks Focused while Rating an FI:
  - Primary Risks i.e. Credit, Market and Operational Risk; and
  - Secondary Risks arising thereof.

- The Form of Risk may Change through the Life of an Islamic Transaction

- The various Modes of Financing in Islamic Banks can be Categorized as:
  - Sharing Contracts, e.g. Musharakah & Modaraba;
  - Trade-based Contracts, e.g. Murabaha, Salam & Istisna; and
  - Service-based Contracts, e.g. Ijarah

Risks & Modes of Islamic Financing

- **Market Risks: These are present in the Banking Book due to Murabaha, Ijarah, Salam and Diminishing Musharakah Financing in the Bank's Asset Portfolio;**
- **Price Risk: Arises on account of the transaction having been based on the sale and purchase of an asset. While the bank owns the asset, it is subject to adverse movements in its price;**
- **Credit Risk: Once the Asset has been Sold to the Client or Payment has been made in any form by the Financier the Exposure bears Credit Risk.**

Risks & Modes of Islamic Financing

- The Severity of Shari'a Rulings Vary in Different Jurisdictions, Impacting the Severity of Risks;
- The Threat of Non-Performance occurring in Assets is also More Severe because it Causes Economic Loss;
- Bankruptcy Initiation & Financial Restructuring of Transactions can make Losses More Complicated in IFIs;
- As the Receivables under Islamic Contracts are Non-Sellable, Non-Performance may also cause Liquidity Stress for the IFI.

Operational Risks in IFIs

- A Higher Degree of Operational Risks may be Expected in Islamic banks;
  - Negligence in Shari'a Compliance can cause Losses to an Institution;
  - Income from Transactions Violating Shari'a Cannot be Recognized as Investment Accounts become Liabilities;

- To Mitigate Operational Risks:
  - Extensive Documentation Required in Islamic Transactions;
  - Greater Importance laid on Correctness and Comprehensiveness of Documents.

Role of IFSB

- The Islamic Financial Services Board (IFSB) Established:
  - Working Group for Risk Management; and
  - Working Group for Capital Adequacy Framework

- The Working Groups have Identified the Credit, Market, Business and Operational Risks Associated with Islamic Products;

- Also Identified Risk Weights for Computation of Required Capital Reserves.

Liquidity Risks in IFIs

- Liquidity Risk may be More Critical in IFIs due to:
  - Lack of Liquidity Management Vehicles;
  - Fewer Participants; and
  - An Underdeveloped Inter-bank and Active Secondary Market

- Absence of Tradable Islamic Instruments is a Major Issue;

- Central Banks Cannot Act as 'Lender of Last Resort' for IFIs.

Going Forward

- Rating Agencies to Direct More Resources towards Further Research;
- Ratings of IFIs require a Common Yardstick to be Used by Rating Agencies;
- Rating Scales should be able to Add Value to Investors' Needs.

Thank You