

**RATING of ISLAMIC BANKS and FINANCIAL INSTITUTIONS**  
**Bahrain, December 10, 2005**

Honourable speakers and respected guests, Assalam-o-Alaikum.

Thank you for letting me have the opportunity to share my views on the ratings of Islamic financial institutions. About two years back this topic had been discussed at a day long workshop that brought together the world's leading rating agencies, both the Global Credit Rating Agencies and the Domestic Credit Rating Agencies here in Bahrain by IFSB. While issues brought to the fore back then are still largely debatable, I will nevertheless share with the audience as to how our thought process has evolved at JCR-VIS.

My presentation covers the debate of the usefulness of the conventional mindset that governs ratings for financing obtained through conventional modes vis-à-vis a tailor made methodology for Islamic financial institutions and in what manner and to what extent is the latter likely to differ from the former. Islamic financial institutions particularly commercial banks are growing remarkably rapidly – a fact bound to be extensively discussed in this conference. What I would like to submit is that the evolution of any financial system, of which banking, insurance and capital markets are the three integral pillars, is rooted in the confidence of the various participants in the system and while the role of ratings is important, we need to work within a rating framework that serves the investors' needs, provides the right checks and balances in the system and fully appreciates the nature of Islamic transactions.

By definition, ratings are independent opinions on the repayment capacity of the issuer or an issue, and have been instrumental in the growth of capital markets and banking in the modern world. As custodians of large amounts of public funds, banks have a fiduciary responsibility of the highest order and a third party opinion on the financial strength and the repayment

capacity of the institution has obvious importance. Bank failures can have serious repercussions on the confidence level of all market participants that can trigger system-wide crisis. The requirement for transparency in the financial sector is accordingly quite high. Disclosure requirements have also been included as an essential element of Basle II.

While transparency and the acknowledgement of the investors' right to know drives any financial system, I believe it has a special place in an Islamic system. It may be interesting for the audience that Islamic banking in Pakistan got its impetus from a judgement passed by the Supreme Court on the subject of 'riba'. Proceedings also referred to the fact that there are elements other than riba that are required to render a transaction Sharia compliant – in fact Sharia principles have outright prohibited financial transactions which are not free of 'gharar' or ambiguity, thereby acknowledging the investors' right to know what he invests in, not just as an element that facilitates the sale of a product like in conventional markets, but by categorically denouncing such an ambiguous transaction as being null and void.

An Islamic bank essentially acts as either an 'ameen' or as a 'modarib'. 'Amanah' accounts are non-remunerative and therefore not subject to variability in returns, while PSIA accounts pay a return as compensation for the possibility of loss that is to be borne by the investor. 'Amanah' accounts are closest to conventional credits and therefore can be assigned credit ratings. However, PSIA accounts pose a challenge to both the concept of default in terms of its validity in ratings of these investments as well as the relevance of credit rating scales conventionally used and therefore the methodology to be applied. PSIAs are not liabilities in the conventional sense and investment account holders are not creditors. Therefore the concept of default that serves as the basis underlying ratings requires re-defining, and needs to be fully understood by market

players. In conventional ratings, default is defined as the lapse of payment when due. Essentially it is the violation of a financial contract. However, an Islamic contract as we all agree is more on a best efforts basis rather than a promise to pay. Therefore, nominal loss to the investor may not constitute a contractual violation. However, we believe that the investor would still be chiefly concerned about the stability of his investment value. While this much is obvious, what requires some debate is what yardstick then ought to be used by rating agencies. Even if loss of invested capital is taken to be a default regardless of the nature of the contract, should the timeliness of that payment be given the same importance as in conventional ratings or should assessing the prospects of ultimate recovery be the rating objective.

Another important aspect is the mutability of these accounts into pure conventional credits. While loss on the investment portfolio can be passed to the Investment Account Holders (IAHs), non-payment on account of a lack of liquidity can trigger default very much like liquidity crisis can cause failures in conventional banks. Therefore the treatment of these accounts is not similar to treatment of quasi equity, simply because loss can be shared, as the depositor's claim to his PSIA, net of any portfolio loss attributed to, is not inferior to any other obligation of the IFI. Sharia non-compliance is yet another event that can mutate these accounts into conventional credits without allowing for the allocation of loss. Therefore liquidity risks and operational risks and their likely impact on the IFI's ability to pay on a timely basis are to be examined at least as carefully in an IFI as in a conventional bank. Also, the possibility of primary risks including impairment in investments of an IFI, intensifying secondary risks like liquidity shortages are to be considered in a manner similar to the methodology applied to rating conventional financial institution.

Of critical concern in Islamic banks is 'displaced commercial risk'. In case an Islamic bank incurs a loss to be passed on to its depositors or pays profit below the market rates, this by itself may cause mass deposit withdrawal setting off a liquidity crisis. In this case shareholders may be required to protect the investment account holders from losing their investment value by foregoing their share of profits. Creation of reserves, i.e. the Profit Equalization Reserve and the Investment Risk Reserve, created with the express objective of providing cushion to depositors and smoothing returns, gives significant strength to ratings once these reserves are large enough to be meaningful in the institutional context. Also noteworthy is the question of 'Hiba' or gift that can be made by shareholders to make good the loss to IAAs, in order to preserve the bank's franchise and not hurt investor confidence that banking is particularly sensitive to.

While many may still argue that treating capital loss as default may not be in line with the spirit of Islamic profit and loss based investments and that Islamic institutions should get preferential treatment on account of their carrying PSIAs, as investors knowingly invest in these modes. It is important to ensure that the very nature of these transactions should not be allowed to cause a banking crisis. Protection of capital and stability of returns is very important to maintaining the confidence in banking systems.

While the rating methodology would continue to focus on the FI's specific risks that can cause institutional failure in both a conventional and an Islamic financial institution some variation in the overall approach to ratings will be required to cater to the various types of liabilities. Eventually rating scales need to appreciate what is of real value to investors. The mudarib's

performance given his economic environment and the performance of his peers in delivering the maximum value to investors in Islamic investments will receive a higher degree of weight than such considerations normally do in conventional ratings. The precise objective of the IAHs will perhaps best be served through stability of return ratings. These ratings, will tend to be more sensitive to the integrity and expertise of the modarib as an asset manager as the investor's dues are a function of this performance and a question on integrity can have implications for the nature of obligation unto investors. This in turn means that Sharia compliance encompassing, but not limited to all principles of corporate governance will have a distinct bearing on ratings. In any case globally rating agencies are now also placing increasing emphasis on corporate governance within their rating framework. However, the aspects of mutability and displaced commercial risk discussed above, as well as the on-demand nature of the PSIA accounts during the normal course of business would strongly support a continued emphasis on timeliness of repayment by the rating agencies.

Rating agencies will largely focus on an FI's primary risks i.e credit, market and operational risks and the secondary risks that may arise thereof. Some peculiarity lies in the fact that 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 and Modaraba

Trade-based contracts, e.g Murabaha, Salam and Istisna and

Service- based contracts, e.g Ijarah

Financing in Islamic banks is primarily extended in the form of service based and trade based transactions that allow banks to manage and control returns to their investment and permit a high

degree of certainty to income streams. Musharakah and modaraba based investments are relatively less frequently used as they entail uncertainties akin to investing in equities.

In case of conventional banks, market risks emanate in the trading book, while in case of Islamic banks, these are present in the banking book due to Murabahah, Ijarah, Salam and Diminishing Musharakah financing in the bank's asset portfolio. Price risk arises in these Islamic contracts 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. Risk mitigating features however are usually built into these contract forms. 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.

The severity of Sharia' rulings vary in different jurisdictions which also impacts the severity of market and credit risks that may have to be faced by an institution. Means of risk mitigation or parallel contracts may be allowed in some jurisdictions and prohibited in others. Ratings will therefore have to be mindful of the strictness of the prevailing rulings.

The threat of non-performance occurring in assets is also more severe as once delayed, profit cannot be earned on investment and economic loss is almost assured. There are further complications as regards bankruptcy initiation and financial restructuring of transactions in case of payment failure. Further, receivables created under Islamic contracts may not be sellable and therefore non-performance under these transactions may cause liquidity related stress more easily for IFIs.

Assessments of IFIs also need to take into account the impact of variations in Sharia rulings on significant areas in different

jurisdictions or even by the Sharia Boards of different IFIs in the same jurisdiction. This is further complicated by the absence of any substantial case law as to how the courts would treat the interest of the PSIA holders in the event of bankruptcy of an IFI. For example, if the court was to attribute the bankruptcy to negligence of the modarib then the entire principal of the PSIA accounts would be transformed into an obligation pari passu with the other unsecured liabilities of the IFI

In addition to the general operational risks arising from inadequacy of systems as faced by conventional banks, a higher degree of operational risks may be expected in Islamic banks on account of the fact that negligence in Shari'a compliance can cause losses to an institution. If a transaction is found to be in violation of Shari'a, the bank cannot recognize income on the transaction. As mentioned earlier, in this case, the investment accounts of the bank lose their equity characteristics and become liabilities. Further, extensive documentation is required for Islamic transactions and its correctness and comprehensiveness is of utmost importance. In case of non-validity or unavailability of a document, the income on the transaction is declared inadmissible and has to be given in charity.

The Islamic Financial Services Board (IFSB) headquartered in Malaysia has established two working groups for risk management and capital adequacy framework. The working groups have identified the credit, market, business and operational risks associated with each Islamic product and based on these risks has identified risk weights applicable for computation of required capital reserves.

Secondary risks, the most significant of which is liquidity risk may be more critical on account of lack of liquidity management

vehicles, fewer participants & an underdeveloped Inter-bank and active secondary market. On account of a limited number of Islamic banks or branches and further the smaller volumes of financial resources at the disposal of these institutions, the inter-bank market does not allow for effective liquidity management. A primary issue is the absence of tradable Islamic instruments. Access to capital markets and investment avenues are limited.

Also to be kept in mind is the role of the central bank in providing a strong layer of support to a bank through its function as the lender of last resort. Technically, the central bank cannot lend to an Islamic bank to avert a liquidity crisis.

These issues are still being discussed at various forums and rating agencies ought to divert resources towards collating these arguments into a whole. IFSB is arranging yet another conference of rating agencies in the early part of 2006 to discuss rating related issues and hopefully arrive at a more or less similar framework for ratings of IFIs that are fair to the market while also serving the purpose of protecting banking systems in Islamic countries.