

RATING of ISLAMIC BANKS and FINANCIAL INSTITUTIONS

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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. Some of us may remember that about two years ago, rating agencies had been brought together in Bahrain by IFSB to discuss the nuances of rating an Islamic investment. More particularly the debate had devolved down to the ratings of a musharakah or a modariba where the returns to the investment are subject to the performance of the underlying business, unlike an investment made in the mode of a 'murabaha' or an 'ijarah' which is similar to a conventional form of investing in that a predefined amount is payable at a predefined time. The purpose of this gathering here is the rating of these unconventional profit and loss based investments. We believe that at JCR-VIS we have refined the logic underlying our approach to these ratings which I will share with you and hope to reach some definite conclusions on the subject.

Quite obviously the utility of ratings is in the fact that it serves to protect the investor by keeping him informed of the risk in an investment in as far as they indicate the probability of loss or default.

However, by definition default is the failure to discharge a duty. Although in the financial context it has come to be understood as 'failure to pay', it is technically defined as failure to discharge a legal duty or in other words, violating the terms of an agreement. PSIA's are not liabilities in the conventional sense and the nature of the agreement does not preset the amount of the obligation. An Islamic contract is more on a best efforts basis rather than a promise to pay.

Islamic banking functions around the concept of asset management. Therefore one approach to ratings of these investments could have been rating the modarib in terms of his ability to deliver as a fund manager, i.e like a governance or a management quality assessment. This would be similar to the way an asset manager of collective investments (mutual funds) is assessed in western markets and even in some local markets like Pakistan.

The drawback to this approach is obvious. It would not provide investors with a measurement of risk to an investment, as do conventional credit ratings. This concept of measuring risk through ratings forms the cornerstone of the edifice of the capital adequacy framework of banks drafted by the IFSB. Throughout the document ratings of IFIs are used as indicators of risk of these institutions. Also as custodians of large amounts of public funds, a third party opinion on the repayment capacity of a financial 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 risk

ratings in the financial sector is accordingly quite high. JCR-VIS therefore believes that ratings of IFIs should essentially serve the same purpose as credit ratings do for conventional banks. While modifications to methodology and/or rating scales are necessitated by the nature of these investments, the institution's repayment capacity is the underlying concept to our ratings of musharakah and modariba based investments of IFIs. JCR-VIS is therefore using the same rating scale for PSIA's as the one being used for conventional ratings, with ratings denoting the probability of loss in investment value. To elaborate more on repayment capacity or investment value we can discuss each type of investment in IFIs in some detail.

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. Here investment value is the capital value of the amount deposited. PSIA's on the other hand pay a return as compensation for the possibility of loss that is to be borne by the investor. In some jurisdictions, these accounts do carry an expected rate of return as indicated by the management. We consider loss in investment value to signify any loss in capital invested as well as a return below the stated expected return. In cases where expected return is not indicated, a rating agency that expects returns on such an investment falling below what can reasonably be expected given the institution's market position and market rates will also be able to justify reduced ratings.

To complete the discussion on ratings of IFIs, rating agencies will assess all primary and secondary risks in a financial institution in a manner similar to the assessment in conventional FI. An important aspect to be considered is that while loss on the investment portfolio can be passed to the Investment Account Holders (IAHs), events such as a liquidity crisis can trigger non-servicing of demand deposits against withdrawal pressures. Therefore the simplistic treatment of these accounts as equity or quasi equity is not reflective of the fact that withdrawal pressure on PSIA's in an IFI render secondary risks arising from liquidity shortages as critical as demand deposits do in conventional banks.

A unique aspect of IFIs ratings is the requirement of sharia compliance in its dealings. Sharia compliance is an additional aspect to be covered in the rating methodology since Sharia' non compliance can affect the earning potential and more importantly the institution's franchise value.

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.

In the capital adequacy framework for regulatory capital of IFIs as drafted by the IFSB, risk of assets funded by PSIA can be deducted from total risk weighted assets. This is accounted for by the fact that if loss is incurred on risk assets funded by PSIA, it can be passed to investors and shareholders' equity is not required to make good this loss to investors, i.e if loss is incurred the IAHs will bear the loss. However, with the primary objective of ratings being to inform investors of the risk to investment value, ratings of an IFI are likely to fall in case it incurs a loss, since the investor is now at higher risk of losing his capital. The fact that capital cannot be applied to make good this loss is likely to further depress ratings.

Noteworthy here is the question of 'hiba' or gift that can be made by shareholders to redeem IAHs in order to preserve the bank's franchise and not hurt investor confidence that banking is particularly sensitive to. The allowance to make a gift may have a positive impact on ratings and sponsor strength will continue to be an important factor, however, given the fact that a gift cannot legally be enforced, it cannot be a substitute of capital in a conventional bank where it automatically absorbs losses before passing it on to depositors.

While many may still argue 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 or their treatment by regulators and rating agencies should not be allowed to cause a banking crisis.