

Ratings of Islamic Financial Instruments
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Assalam-o-Alaikum Ladies and Gentlemen,

Thank you for the opportunity to once again share our thoughts and experiences before so many distinguished guests in this beautiful country. It is a matter of great satisfaction for Islamic scholars and those who laid the foundation of Islamic finance in modern times, that today this concept is widely appreciated as a fair and transparent system by secular experts world-wide. The recent happenings in the world's financial markets have reminded us that adhering to the Islamic spirit of business transactions cannot be waylaid in favor of expediency and in an attempt to 'adapt' a transaction to western requirements of certainty in its outcome. Much of course is yet to be done on this front.

While the prevailing recession in global markets has depressed new issuances everywhere, sukuks have comprised a growing proportion of total capital market transactions. Global Islamic capital markets exceed USD150m. In Pakistan, the rated sukuks outstanding are a major portion of total capital market issuances over the last two years. Ijarah and Diminishing Musharakah based sukuks remain the most frequently used to source funds, although globally, other structures like Istisna and Murabaha based structures are also in issuance.

Ratings of sukuks are fundamentally driven by the strength of the business and its cash flow generating or earning capacity. Evaluation of the risks or risk mitigating factors in a transaction as inherent in its structure, i.e. the mode of finance used will pose different risks and safety measures for investors and will also be a key determinant of ratings assigned. While these remain the key rating drivers, critical concepts that have been consistently raised are the concepts of default and notching of rated issues. The relative emphasis of rating agencies on Shariah compliance or as more recently debated, Shariah governance, can also eventually have implications on the legal enforcement of a transaction's structural elements. I

will discuss these factors in some detail as we go along, starting with the concept of default and the rating scales.

The concept of default may not be applicable to Islamic finance in its strictest sense of not meeting a legal obligation; without discerning between malpractice and genuine business failure. However, for the most basic of practical purposes that concern an investor, a similar concept can be applied to ratings of Islamic issues. To the extent that a borrower is not able to return even the original sum invested within the agreed term, it can be termed as a loss to investor and denominated accordingly at a rating level, commensurate with 'D' ratings.

The concept of notching is also at a variance to its typical application in conventional issues. Ratings reflect the underlying structure of the sukuk, varying if it is asset backed or equity based (Musharaka and Mudaraba sukuk). The quality of the pool in case it is asset backed, is another consideration and certain other Shariah compliant enhancements can also be embedded in the structure, which may impact ratings.

Junior and senior claims are not usually prevalent in Islamic structures and notching can only be applied when in case of asset backed structures, the earning streams can be segregated and there is reasonable certainty that this distinction will not be over-ruled in a court of law. Depending on the quality of the pool backing an instrument, its ratings may be notched up or down. Internationally notching up is not commonly practiced as a true sale is not usually ensured in these transactions.

The more common structures being employed are Ijarah based or Diminishing Musharakah based. In Ijarah and Diminishing Musharaka sukuks, the sukuk holders acquire pro rata ownership in assets and share in the cash flow streams of the underlying assets.

The first sukuk to be launched in Pakistan was Musharakah Tul Aqd based, i.e. it was based on the concept of profit and loss sharing as partners in the business. While closest to the true spirit of Shariah, Musharaka based instruments pose the highest degree of variability in returns to the investors. In high - growth

companies, these can become expensive sources of funds and during downturns, sukuk holders do not have a claim backed by assets that can be repossessed.

The primary driver of the rating here is the strength of the business model of the issuer and its income/ cash flow generating capacity. The risks presented in the earlier slide can be mitigated.

- through the creation of ‘Takaful’ reserves which takes a contribution from both sukuk holders and the issuer and if unutilized, This amount is proportionately distributed to sukuk holders at the termination of the partnership agreement. However this strength develops over a period of time, as the reserve accumulates and the initial rating can only draw some strength from the mechanism.
- through external credit enhancement from a third party by way of a guarantee. These however are harder to obtain since the guarantor is not entitled to compensation against his risk.

Although these sukuks fared well in terms of meeting expectations of investors, the investing community, largely comprising banks and non-bank financial investors have preferred the rental based structures on account of superior claim over the underlying assets. The nature of these transactions may also determine relative seniority of claims on the originators’ cash flow with rentals being a primary obligation while investors in equity based sukuks would receive a share of profits only after expenses have been paid.

While rating agencies do not comment on the degree of Shariah compliance for a given transaction, the idea of Shariah governance has become an important element in ratings. It is important to cultivate the understanding of Islamic finance among analysts concerned with sukuk ratings so as to better assess the likelihood of an early winding up of a transaction and the corresponding stress in cash flow. JCR-VIS includes a scrutiny of Shariah audit reports in case of Islamic institutions and stresses upon independent Shariah advice to assess a transaction’s compliance with Islamic jurisprudence. This is also of vital significance to understanding the inherent risks and risk mitigation inherent to each structure.

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The recent discussion of standards applicable to sukuk structures being employed raised some important points with implications on ratings. While ratings of sukuk already in issuance may not be affected by these recommendations, new sukuk issuances may call for renewed thoughts on ratings being assigned by international rating agencies, which have so far been able to rate sukuk by viewing them as instruments akin to conventional bonds, as certain types of assurances are embedded in them. Most importantly, originators' guarantee to redeem sukuk at face value, or providing loans to sukuk holders when profits fall short of market rates and issues regarding transfer of ownership rights are now being vastly argued as not being in accordance with Shariah interpretations. The market is likely to be further strengthened as the thought process of market participants evolves and more robust structures come to light.

Thank you.