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# The Meaning Of Ratings For Islamic Financial Institutions

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# The Meaning Of Ratings For Islamic Financial Institutions

Islamic financial institutions (IFIs) differ from conventional banks in several important ways, yet Standard & Poor's Ratings Services assigns ratings to financial institutions globally, regardless of their economic nature, legal form, or specific features. The ratings scale we apply is the same for all issuers, with some exceptions pertaining, for example, to national scale ratings, stability ratings, or fund ratings. So far, IFIs, a specific class of financial intermediaries compliant with "Sharia," or Islamic law, have been assigned global scale ratings, which do not differentiate them from any other conventional bank requesting a credit rating from Standard & Poor's.

As Islamic finance starts to play an increasing role in both Muslim and non-Muslim markets, it is useful to explore IFIs' often subtle particularities, especially when it comes to rating their funding instruments (see "Enhancing Financial Reporting And Transparency: Keys To The Future Of Islamic Finance," published Dec. 14, 2005, on RatingsDirect).

Most importantly, the profit-sharing nature of some IFI funding instruments makes it difficult to ascertain at what point they enter default. A distinct analysis may be called for to convey not so much an opinion on default probability, but rather an opinion on the stability of the returns provided to investors. In addition, Standard & Poor's method for rating bank "sukuk" (Islamic notes) has to take into account the wide variety of possible structures for issuing notes compliant with Sharia (see "Rating Sukuk--How Rating Methodologies Apply To Islamic Debt Financing," published Sept. 13, 2003, on RatingsDirect).

## The Specific Nature Of IFIs' Funding Instruments

IFIs, like other banks, are involved in intermediating cash flows, and share in the same risk categories as their conventional peers. To evaluate risk, Standard & Poor's applies the same analytical framework to IFIs as it does to any non-Islamic bank (see "Standard & Poor's Classic Ratings Approach Applies To Islamic Banks Despite Sector Specifics," published Aug. 31, 2006, on RatingsDirect).

One of the specificities of Islamic finance, however, is the nature of IFIs' funding instruments. Apart from shareholders' equity, IFIs resort to a series of funding sources:

- Sight deposits and current accounts, which are not remunerated at all;
- Sharia-compliant asset-backed term deposits from bank and nonbank customers;
- Profit-sharing investment accounts (PSIAs); and
- Sukuk, or asset-backed Sharia-compliant notes.

The first two categories of funding instruments are not materially different from their conventional equivalents, despite the commodity-based nature of term deposits. Conversely, PSIAs and sukuk are unique to Islamic banks. According to the core principles of Islamic finance, investors and entrepreneurs must share the risks and returns of a given venture. PSIAs allow their holders to share in an IFI's profits, but also in its eventual losses. PSIA contracts cannot be rated in themselves, mainly because it would be almost impossible to identify default on each individual contract, bearing in mind that a negative return on a PSIA would not be considered a default, as PSIAs are loss absorbing (see "Standard & Poor's Looks At Features Of Islamic Banks' Unique Funding Instruments," published



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June 15, 2005, on RatingsDirect).

IFIs can indeed default on their financial obligations, though, irrespective of the nature of their liabilities. Default would affect each funding instrument differently.

### Current, unremunerated accounts and term deposits

An IFI would default on a current, unremunerated account if it were not able or unwilling to pay back the full nominal amount of the deposit when a customer asks for a withdrawal. Similarly, an IFI would default on a term deposit if not able or unwilling to pay back, at maturity, either the principal or the markup agreed upon with the customer at the inception of the deposit contract.

For deposits, there is therefore no difference in the definition of default between conventional and Islamic banks. Default might occur because of insufficient liquidity, or because of material losses--triggered by credit risk, market risk, or operational risk--capable of jeopardizing the bank's solvency.

### Profit-sharing investment accounts

As far as PSIAs are concerned, defining and identifying default is less straightforward. Under a profit-sharing agreement, the depositor agrees--for a given maturity--to share in the profits (or losses) extracted by the bank from the pool of assets financed by the PSIAs. These are then called unrestricted PSIAs, because it is the bank's responsibility to define and manage these underlying assets on its own balance sheet. Investments in restricted PSIAs, on the other hand, are selected by the investor, and thus resemble more closely assets under management, which are off the bank's balance sheet.

For unrestricted PSIAs, neither the returns nor the principal is guaranteed. Even if an Islamic bank makes a loss that impairs the principal value of a PSIA, Standard & Poor's would not recognize default, because no contractual obligation would be breached. Only in the case of management misconduct or negligence would the bank be liable for all losses incurred. Then PSIA holders would be entitled to receive full repayment of their initial investment. With restricted PSIAs, the investor entirely takes on investment risks, whereas the managing bank faces only reputation risk and opportunity costs if the underlying assets do not perform in line with investor expectations.

The profit allocation between the bank (and its shareholders) and the unrestricted PSIA holders is dictated by a profit-sharing formula agreed upon when the contract is signed. Our analysis of when default might occur depends on the details of bank's various financial obligations predefined in the PSIA contract. In the case of a major bank loss, PSIA holders could ask to withdraw their funds at maturity, especially if the funds are impaired below the nominal value of the PSIA. It is possible that the bank would be unable to pay customers back the fair amount of the PSIA, albeit impaired. In other words, the bank would redeem less than face value minus the customer's share in losses. In that case, we would consider the contract to be breached.

To mitigate the risk taken by PSIA holders when they agree to share the bank's risks and returns, Islamic banks have built profit equalization reserves and investment risk reserves into the PSIA structure. These reserves smooth the returns provided to PSIA holders across the economic and business cycle, and thus reduce the risk of negative returns that could trigger a liquidity crisis (massive withdrawals of deposits and PSIAs), which in turn could worsen into a solvency crisis leading to default. These reserves are important from an analytical perspective, because they tend to reduce liquidity risks and enhance depositor confidence. If material losses deplete these reserves, the probability of substantial withdrawal of depositors' funds increases, and could accelerate the IFI's liquidity and solvency problems.



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**Sharia-compliant notes, or sukuk**

The same kind of analytical framework applies to defaults of bank sukuk. With sukuk guaranteed by the originator of the underlying assets, a default would be recognized when the originating Islamic bank fails to pay either the principal of the sukuk, or the returns agreed upon at the beginning of the contract. The "sukuk al-musharaka" recently issued by Sharjah Islamic Bank (SIB; BBB/Stable/A-2) and extensively described and analyzed in a presale report was the first bank sukuk in the Gulf and was guaranteed by SIB as the originator, manager, and co-owner of the underlying assets (see " Presale: Sharjah Islamic Bank's Sukuk Trust Certificates," published Sept. 12, 2006, on RatingsDirect). SIB gave sukuk holders its promise to provide the necessary Sharia-compliant funding to cover any shortfall, should the cash flows generated by the pool of underlying assets be insufficient to pay for the floating sukuk coupons.

For nonguaranteed sukuk, however, the profit-sharing concept applies, and failure to provide positive returns or pay back the nominal value of the notes would not be considered, in itself, as default. Only impairment above the fair losses that the investor is supposed to bear would be considered as a breach of contractual obligations.

## Profit-Sharing Investment Accounts: Looking Into A Specific Analysis

Because it would be virtually impossible for Standard & Poor's to perform the thorough surveillance of each and every PSIA at all times, PSIAs cannot be assigned credit ratings. A PSIA holder should refer to the ratings of the Islamic bank offering the PSIA as the best indicator of the PSIA's overall creditworthiness as measured by a given probability of default. Default in this case, as explained above, is not specific to PSIAs, but involves any breach of contractual obligations with fund providers other than shareholders.

As credit ratings are not applicable to PSIAs, Standard & Poor's is looking into alternative ways to evaluate IFIs' PSIAs. One approach would be to assess the variability and sustainability of the returns on PSIAs.

## Rating Bank Sukuk: The Dual Approach

Standard & Poor's has already developed a methodology to rate sukuk, be they issued by sovereigns, banks, or corporations. The same approach could be applied more generally to any type of issue, including securitization transactions that would fall under our structured finance criteria. The vast majority of bank sukuk are ratable financial instruments.

Standard & Poor's makes a distinction between Islamic contracts unrelated to profit sharing, and those in which a profit-sharing agreement is embedded. The former category is more easily ratable than the latter, all the more so as sukuk with no profit-sharing contents are made of "ijara" sukuk (lease-backed obligations) and "murabaha" sukuk (markup financing), which more easily benefit from the guarantee of the originator of the underlying assets, regardless of the performance of the sukuk. When Standard & Poor's has enough comfort with the timely, irrevocable, and unconditional nature of the guarantee, the ratings on the sukuk are equalized with those on the originator, provided that the obligations pertaining to the sukuk rank equally with the originator's other senior unsecured liabilities (see "A Closer Look At Ijara Sukuk" and "Two Aspects Of Rating Sukuk: Sharia Compliance And Transaction Security," published Feb. 2, 2005, and Jan. 16, 2006, respectively on RatingsDirect). In the latter report, we address the issue of whether or not Standard & Poor's factors Sharia compliance into its ratings. For various reasons, Sharia compliance has not featured in Standard & Poor's rating analysis.



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If sukuk do not receive a guarantee from the originator of the assets underlying the sukuk structure, or if Standard & Poor's has no comfort in the guarantee's timely, irrevocable, and unconditional nature, the sukuk issuance may or may not be ratable. Ratable sukuk would be considered more like securities issued under a securitization transaction. The ratings on that type of sukuk would be determined according to Standard & Poor's structured finance criteria, and ratings would depend both on the specifics of the transaction itself and the creditworthiness of the originator of the underlying assets.

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