The Next Evolution In Rating Islamic Financing Instruments : From Islamic Debt Rating (*ID*) to Islamic Investment Quality Rating (*IQ*)

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With the emergence and rapid growth of the Islamic finance industry, Malaysian Rating Corporation Berhad (MARC) has witnessed a proliferation of Islamic financial products, in terms of depth, breadth and sophistication. MARC lays claim to being the first rating agency that has a specific set of rating symbols and definitions for the ratings of Islamic capital market instruments. Soon after its inception, MARC established its own Syariah Advisory Panel to advise on Syariah aspects of Islamic financial instruments as well as to review and endorse new variations to Islamic rating products and definitions. The main driver behind this initiative is the fact that conventional rating symbols should only be appropriate for interest-bearing instruments. Islamic bonds, meanwhile, generate profit payments in place of interest – a distinction that is fundamental to Syariah-compliant investing. Apart from the absence of interest-based ***(riba)*** transactions, the avoidance of economic activities involving speculation ***(gharar)***, the elimination of exploitation of either party and the prohibition of financing the production of goods and services which contradict the Islamic ***(haram)*** are also fundamental to Syariah compliance. While scholars agree on these main principles, there are differences in interpretation between various schools of Islamic religious jurisdictions. From MARC's experience of rating Islamic financing instruments, we find that the issue of Syariah compliance is generally adequately addressed by the appointed Syariah panel of Lead Arrangers and Financial Advisers. If MARC is the appointed rating agency for the transaction, issuers and investors would also have the added validating endorsement of the Syariah-compliant from MARC's own Syariah Advisory Panel.

In recent years however, it has become apparent that the evolution of Islamic finance has progressed beyond a replication of conventional products to the development of real Islamic financing alternatives. The foregoing has taken place within the context of the increasing amounts of Syariah compliant capital and accordingly, the demand for Syariah compliant financial products and services. MARC has kept pace with the evolution in Syariah compliant financial products and services and responded thereafter by introducing new rating products and rating symbols.

MARC currently provides ratings for Islamic Bonds and Islamic Sukuk issuances. The analytical framework for rating Islamic Bonds is broadly similar to that used in rating conventional Bonds. There are no major differences in MARC's rating approach for debt-based Islamic financing instruments. These ratings specifically assess the likelihood of full and timely payment of obligations to holders of the instrument issued under the various debt-based Islamic financing contract(s), which can be likened to the concept of probability of default in conventional debt ratings. MARC assigns Islamic Bonds ratings on long-term and short-term rating scales that are comparable to its other credit ratings. The scale ranges from 'AAA_{ID}' to 'D_{ID}' for a long-term rating (with maturity of more than one year), and from 'MARC-1_{ID}' to 'MARC-D_{ID}' for a short-term rating (maturity of up to one year).

Since 2001, MARC has also been assigning Islamic Sukuk ratings to fixed income Sukuk issuances. In common with MARC's conventional debt and Islamic debt rating scales, the long-term Sukuk rating scale comprises eight rating categories ranging from 'AAA_{IS}' to 'D_{IS}', while the short-term rating scale ranges from 'MARC-1_{IS}' to 'MARC-D_{IS}'. The introduction of a different set of symbols for Sukuk obligations recognizes the fundamental difference between Sukuk and other fixed-income Islamic debt obligations. Sukuk are asset-backed, Syariah-compliant investment certificates, usually used in conjunction with an Ijara (lease rentals) structure or a Musharakah (profit sharing structure). Again the rating focus for fixed-income Sukuk, is on timely payment with added analytical emphasis on the 'beneficial interest' conferred by holding a Sukuk. This 'beneficial interest' represents a proportional ownership of the underlying asset as well as the income that is generated by the asset. The analytical framework employed in rating Sukuk broadly resembles that of asset-backed securities (ABS). In the case of Ijara-based Sukuk rated by MARC to date, the rating has been typically driven by the credit risk of the lessee (who is usually the originator or an entity related to the lessee).

Details of some MARC's rated *ID* and *IS* issues are given below:-

Issuer	Rating	Instrument	Salient features
Optimal Glycols (M) Sdn Bhd & Optimal Chemicals (Malaysia) Sdn Bhd	AAA_{IDS}	RM1.02 billion Al-Bai' Bithaman Ajil Islamic Bonds due 2014	Structural protections include revolving sponsor support for debt service on a several basis of up to USD163 million, which reduces to 30% of outstanding facility amount subject to a floor of USD52 million on a combined basis. The rating primarily reflects the strength of sponsor support which provides downside protection for adverse market and/or operating conditions.
Putrajaya Holdings Sdn Bhd	AAA_{ID}	15 year RM2.20 billion Murabahah Medium Term Notes	The notes constitute an unsecured corporate borrowing of the issuer, to be serviced with sub-lease rental collections from the Government of Malaysia. The rating is reflective of the quality of the payment stream as well as the issuer's credit metrics.
IJN Capital Sdn Bhd	AAA_{IS}	RM100 million Sukuk Musyarakah	Musyarakah ventures (partnership arrangements with the financiers/investors) were set up to finance the refurbishment and improvement works as well as construction of a new hospital block. The issue is backed by Government receivables, a specified percentage of which is captured by a revenue reserve account. The credit quality of government receivables is the key rating factor.
Assar Chemicals Sdn Bhd	AAA_{IS}	RM150 million Serial Sukuk Musyarakah	Under this transaction, Sukukholders have beneficial rights and interest in an independent oil terminal (the construction of which was part-financed by Sukuk proceeds). The terminal is leased to the issuer in return for lease rentals. Sukukholders receive profit from lease rentals. The rating was driven mainly by the lessor/issuer's credit profile which, in turn, was supported by its long-term off-take arrangements for its petroleum products, protected margins and the strategic nature of the issuer's facilities.

The way forward – Investment Quality '*IQ* ' ratings

MARC has also conceptualized a rating product for non-fixed income or variable income Islamic financial instruments that are based on equity and profit sharing. This could encompass instruments based on partnership structures such as Musyarakah and Mudharabah. Under Musyarakah structures, investment comes from both sides - the issuer and the investors. The investors could receive profits in excess of their actual investment contribution based on a pre-agreed ratio but any loss will be shared on the basis of equity participation. In the case of Mudharabah-based structures, there is profit sharing but no loss sharing. Losses are borne by the investors/financiers unless willful negligence or misuse of funds by the issuer has occurred (Mudarib technical mismanagement). Also, the financiers do not interfere in the management of the partnership venture. This is akin to conventional venture capital funding. Like venture capital, the profit sharing requirements of Islamic finance are subject to higher risk of adverse selection. MARC believes that the information asymmetry between the financiers/investors and issuers may be reduced considerably with an independent rating on investment quality.

The focus of Islamic 'investment quality' ratings will be on the assurance of returns and maintenance of the terms of the issuance as opposed to addressing credit quality alone. In the context of variable income Islamic financial instruments, a missed payment does not automatically translate into a 'default'. Further, 'default' would conceivably encompass one or more of the following:

(i) failure to share profit/loss according to the contracted profit and loss sharing ratio;
(ii) instances where the funds for financing economic activities involving speculation/ financing of goods and services that contradict the Islamic value pattern; and/or
(iii) economic loss arising from proven negligence and mismanagement on the part of the issuer/borrower.

Our methodology for analyzing investment quality (*IQ*) is driven by the nature of the investment that is being financed, i.e., whether it relates to a specific transaction or project or to the ongoing business of the entity. MARC has developed a special rating scale for ***IQ*** ratings that consists of seven categories from 'AAA_{IQ}' (highest quality) to 'C_{IQ}' (lowest quality). It should always be borne in mind that such instruments occupy a more junior preferential position in liquidation relative to debt-based instruments and accordingly, no meaningful comparison with the credit quality of debt-based instruments in absolute terms can be made.

If a project is financed, MARC will utilize its project finance methodology. As in the case of conventional project financing, the project's economics (encompassing demand and price risks), capital structure and financial flexibility, construction risk, operation risk, as well as legal, political, and regulatory risk will be analyzed. However, unlike conventional project financing, investors/financiers of a variable income Islamic financing instrument will be participating in the upside of the project. It follows that there will be a lesser need to structure the project financing with significant coverage levels and by funding reserve and contingency accounts as is the case with conventional project finance debt. In the same vein, if the ongoing business of the issuer is identified as the key driver of investment quality, MARC's analysis will incorporate the pertinent aspects of corporate debt methodology, i.e. the assessment of the industry and business risks, its financial profile and management quality. MARC's analysis will also focus on the availability of structural mitigants such as staged financing subject to milestone fulfillment, and restrictive covenants to be observed by the investee in terms of asset sales and other financing taken.

Going forward, MARC believes that the opportunity to undertake an investment quality rating may present itself when investors become more comfortable with investing in variable income instruments which emphasize returns as opposed to mainstream debt-based instruments which are sensitive to changes in credit quality. These instruments are envisaged to also be more aligned to GCC Syariah-compliance principles.