STANDARD & POOR'S

STABILITY RATINGS

S&P Launches Stability Ratings For Islamic Banks Offering Profit-Sharing Investment Accounts

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Most Islamic banks offer profit-sharing investment accounts to their customers. PSIAs are financial instruments that are relatively similar to the time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of the bank's profits, but also obliged to bear all potential losses pertaining to their investment in the bank. This profit-sharing principle is core to Islamic finance, according to which investors and entrepreneurs must share the risks and rewards of a given venture. As PSIAs are loss absorbing, Standard & Poor's Ratings Services' classic credit ratings are not applicable to this class of instruments. We have decided, however, that our stability ratings are applicable and could provide PSIA depositors with a useful opinion about these instruments.

Stability ratings represent Standard & Poor's opinion about the expected stability of cash flow distributable to PSIA holders of an Islamic financial institution (IFI). By stability, we specifically mean the relative sustainability and variability of distributable cash flow, which underpins cash distributions. Stability ratings are neither opinions about an IFI's overall creditworthiness or profitability; nor recommendations to buy, sell, or hold a particular PSIA. Furthermore, they do not comment on the suitability of any investment for a given investor. Investors may find that stability ratings help them understand and compare the expected volatility of the yield served on PSIAs of different banks, particularly as stability ratings are subject more to changes in the characteristics of the institution than to the ebb and flow of market valuations or sentiments.

Our Stability Ratings And How They Apply To IFIs Offering PSIAs

PSIAs cannot be rated with our classic credit ratings, which indicate probability of default. Absence of a positive return on a PSIA, or depletion of its principal would not be deemed default events per se, except in the case of negligence or misconduct, because these instruments should absorb the losses related to the assets they have financed. For details about how PSIAs work in theory and practice, refer to “Standard & Poor’s Looks at Features of Islamic Banks’ Unique Funding Instruments” (published June 14, 2005, on RatingsDirect).

Since publishing that report, Standard & Poor’s has recognized the need to develop a specific ratings methodology tailored to IFIs offering PSIAs. We came to the conclusion that our existing stability ratings, used since 1999 to rate income funds in Canada (see “ Standard & Poor’s Canadian Stability Ratings Criteria Update,” published June 13, 2005, on RatingsDirect), are applicable to IFIs that offer PSIAs, with only a few adjustments. Under a profit-sharing agreement, PSIA holders agree—for a given period—to share in the profits (or losses) extracted by the bank from a pool of assets. These are then called unrestricted PSIAs, as it is the bank’s responsibility to define and manage these assets on its own balance sheet. Investments related to restricted PSIAs, on the other hand, are selected by the investor, and thus resemble more closely assets under management, and are off the bank’s balance sheet. Standard & Poor’s will provide IFIs with stability ratings, which will only pertain to their unrestricted PSIAs.

Definition of stability ratings

A stability rating is expressed through two key components:

- A rating, which represents our current opinion about the prospective relative stability of cash flow distributable to PSIA holders based on its sustainability and variability; and
- An outlook, which expresses our opinion about the trend for the stability rating over a one- to three-year horizon: stable, negative, positive, or developing. StabilityWatch indicates a special surveillance period.

Stability ratings range from ‘SR-1’ to ‘SR-7’. We assign ratings of ‘SR-1’ to IFIs that we believe have the highest level of expected stability of distributable cash flow. Conversely, IFIs rated ‘SR-7’ have, in our opinion, the lowest degree of expected stability.

Outlooks and StabilityWatch focus on scenarios that could lead to a change in stability ratings, because Standard & Poor’s recognizes that future yields on PSIAs depend on many factors. In general, StabilityWatch sets a special surveillance period during which we monitor one or several events for their effect on the rating (see box).

Stability Ratings Scale And Definitions

Rating Level

SR-1
An entity rated 'SR-1' has the HIGHEST level of distributable cash flow generation stability.
SR-2
An entity rated 'SR-2' has a VERY HIGH level of distributable cash flow generation stability.
SR-3
An entity rated 'SR-3' has a HIGH level of distributable cash flow generation stability.
SR-4
An entity rated 'SR-4' has a MODERATE level of distributable cash flow generation stability.
SR-5
An entity rated 'SR-5' has a MARGINAL level of distributable cash flow generation stability.
SR-6
An entity rated 'SR-6' has a LOW level of distributable cash flow generation stability.
SR-7
An entity rated 'SR-7' has a VERY LOW level of distributable cash flow generation stability.

Outlook

The outlook indicates the expected stability ratings trend over a one- to three-year horizon. The outlook is expressed either as stable, positive, negative, developing, or, in special circumstances, as StabilityWatch, indicating a special surveillance period.

Disclaimer

A stability rating is an opinion and is not a verifiable statement of fact. Stability ratings are based on information provided to Standard & Poor's by an issuer or its agents. Standard & Poor's relies on the issuer, its accountant, counsel, and other experts for the accuracy, completeness, and timeliness of the information submitted to it in connection with a stability rating. Standard & Poor's does not perform an audit in connection with a stability rating and assumes no duty of due diligence or independent verification of any information used in the rating process. Standard & Poor's does not and cannot guarantee the accuracy, completeness, or timeliness of the information relied on in connection with a stability rating or the results obtained from the use of such information. Standard & Poor's may raise, lower, suspend, place on StabilityWatch, or withdraw a stability rating at any time, at Standard & Poor's sole discretion. A stability rating is neither a market rating, nor a recommendation to buy, hold, or sell any security.

Stability rating criteria overview

A stability rating incorporates analyses of three aspects of the issuer: structure and governance; business risk profile; and financial risk profile, which includes an examination of the sustainability and variability of distributable cash flow.

Sustainability has a direct relationship, and variability an inverse relationship, with the stability rating level. Sustainability reflects the likelihood that an IFI will remain in existence and continue to generate cash flows to be distributed to PSIA holders. The sustainability assessment draws heavily on our business risk assessment of the institution and some components of our financial risk assessment. For example, an IFI with a predictable and solid business risk profile and a modest-to-average financial risk position is likely to merit a relatively strong sustainability assessment. Sustainability also incorporates conclusions from our structure and governance analysis.

Variability reflects the level, trend, and patterns of distributable cash flow generation, relying heavily on the distributable cash flow and distribution components of our financial risk profile assessment. Variability considers, among other factors, the volatility, trend, and likelihood of a material drop and magnitude of potential decreases in distributable cash flow generation, including in a worst-case scenario. We are likely to give a relatively strong variability score when PSIA returns exhibit minimal volatility and a stable or positive trend. Although we base the variability assessment largely on quantitative measures (in particular the track record of income distributable and distributed to PSIA holders across cycles), qualitative factors such as our evaluation of management's strategy play a role. Growth of or a positive trend in distributable cash flow generation may offset volatility, leading to an assessment of low variability.

Our Methodology For Assigning Stability Ratings

Stability ratings have a robust analytical framework that is divided into several categories, and proceeds in stages to ensure that Standard & Poor's considers the relevant structural, qualitative, and quantitative issues. The stability rating depends on the assigned sustainability and variability scores, which in turn comprise an analysis of the issuer's structure and governance, business profile, and financial profile.

With this analysis, we assess the sustainability and variability of distributable cash flow to be paid to PSIA holders to form our stability rating opinion. However, there is no simple mechanical formula for combining sustainability and variability scores to arrive at a final stability rating, which is ultimately an opinion and captures nuances beyond specific scores.

In assigning stability ratings, we make no distinctions among PSIAs based on their profit-sharing formulas or maturities.

Structure and governance analysis

We analyze the structure and governance of an IFI to determine weaknesses and vulnerabilities that could prevent it from generating and delivering distributable cash flow. Although Islamic banks are organized and managed in many different ways, Standard & Poor's neither views any one structure as nominally good or bad, nor promotes a single correct structure for all financial institutions, Islamic or not.

Structure and governance analysis is carried out on a case-by-base basis. It also tends to be a general qualitative assessment, which focuses on the quality of management, application of policies and procedures, and management accountability. It takes into consideration universal qualities such as the corporate culture, governance, transparency, and other factors that are specific to an Islamic bank.

Business risk profile analysis

Stability ratings also take into account the business risk profile of the bank. We will analyze a set of factors that determine a company's ability to achieve success and avoid pitfalls in its business. Accordingly, Standard & Poor's business profile analysis for stability ratings draws on our classic credit rating approach, which includes an examination of an entity's:

- Industry characteristics,
- Competitive position;
- Diversification; and
- Strategy.

The business profile analysis begins with a general overview of the IFI's prospects within its industry and competitive and regulatory factors affecting this industry. We factor in impacts of business cycles, whether industry or economic, into the assessment. Given limitations that industry risk characteristics pose, we determine the ultimate business profile for each IFI based on such competitive dynamics as market share, pricing power, and diversification. In addition, we assess the management team's role in determining and affecting operational success, as well as its track record.

The business risk profile analysis provides important input for evaluating the sustainability of distributable cash flow generation. We believe that the business risk profile also affects risk tolerance, as a solid business position implies greater potential staying power. In addition, we consider that a clear understanding of an IFI's revenue and cost cycles is critical to understanding variability.

Financial profile analysis

We base our financial profile assessment mainly on quantitative measures, particularly financial ratios, but we also take into account qualitative components. To calculate financial ratios used in determining stability ratings, Standard & Poor's makes its customary credit rating adjustments to financial statements, such as the inclusion of off-balance-sheet items to facilitate comparability among peers, whether they are Islamic or not. The financial risk evaluation includes an analysis of:

- Accounting and financial policy, including distribution policy;
- Cash flow adequacy and distributable cash flow;
- Asset quality;
- Profitability; and
- Liquidity, financial flexibility, and the funding mix.

Surveillance And Rating Changes

Our surveillance of stability ratings is an ongoing process. This includes an annual meeting with the institution's management and a review of stability ratings at least once a year by a Standard & Poor's rating committee. We also expect to receive quarterly a set of financial information, including audited or at least reviewed financial accounts, as well as any relevant management information pertaining to PSIAs—especially all data regarding profit sharing, and actual as well as expected returns payable to holders of PSIAs.

Stability rating actions will be linked to changes in the characteristics of their primary building blocks: structure and governance, and business and financial profiles. Moreover, stability rating actions consider the degree to which an eventuality had already been incorporated into the analytical process. In other words, an event could have varying degrees of consequences, depending on the extent to which we already incorporated its implications in the existing stability rating. An event can have four different outcomes, some of which may occur simultaneously:

- No change in the outlook or level of the stability rating. This could indicate an event that is already fully incorporated in the stability rating or not significant enough to affect the IFI's profile, or one that alters Standard & Poor's view of the stability rating opinion, but not sufficiently to warrant change.
- The outlook on the rating is revised, including placement on StabilityWatch. Outlook revisions indicate a directional change in stability ratings, and generally state the conditions under which a stability rating action could take place.
- The stability rating is raised or lowered. A change in a stability rating generally reflects a major shift in the sustainability and variability of PSIA returns, and therefore of the fundamental risk profile attached to them.

It is worthwhile to note that stability ratings are not just a snapshot of the current profile of PSIAs, but rather our opinion about how they may perform throughout the ups and downs of business and industry cycles. Our stability ratings in general can withstand normal cyclical pressures. The actual pattern and longevity of any given cycle and its potential long-term effects are nevertheless challenging to predict with a high degree of precision. We would revise a stability rating if the business or financial profile of the bank, and therefore the sustainability and variability of its distributable cash flow generation, is permanently altered.

The stability rating scale includes seven rating categories that have no notches (indicated by the designations '+' or '-'). For that reason, we expect that stability ratings will undergo fewer rating actions than our classic credit ratings (which have three notches for categories 'AA' through 'CCC').

The sustainability component of stability ratings is based on fundamental, structural factors, which are also important factors driving credit ratings. For that reason, we expect the sustainability assessment to correlate materially with our credit ratings.

In contrast, the variability component of stability ratings largely reflects cyclical factors, which affects the business profiles of IFIs less than their short- to medium-term financial profiles. Cyclicality would need to be sufficiently ample on the upside or downside, however, to by itself trigger an upgrade or a downgrade of a stability rating.

A New Service By Standard & Poor's

The application of stability ratings to IFIs is a new service Standard & Poor's is offering to Islamic banks. We will endeavor to ensure that our approach to stability ratings is well known and understood, and we welcome comments from market participants about our initiative. We remain committed to refining and tailoring our stability ratings criteria and methodology to changes and innovation in the marketplace.

As fundamental analysis of the creditworthiness of a bank issuing PSIAs is an essential part of our assessment of stability, an IFI needs an issuer credit rating (ICR) in order to obtain a stability rating. Although we can assign credit ratings without assigning stability ratings, an ICR on a bank is a necessary prerequisite for a stability rating.

Appendix: Related Articles

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