



الوكالة الإسلامية الدولية للتصنيف  
Islamic International Rating Agency

**The 15<sup>th</sup> Annual World Islamic Banking Conference (WIBC)**

# **Rating Workshop**

**Sunday 23<sup>rd</sup> November 2008  
Gulf International Convention Centre  
Kingdom of Bahrain**

# Agenda

- Introduction to Ratings, their Functions and History
- Ratings in emerging Markets
- Key Analytical Approaches to Different Types of Ratings
- IIRA's Rating Process
- Q&A

# What is a Rating?

An independent, objective opinion regarding the relative capacity to meet financial obligations on time, including Islamic returns

# A Brief History of Ratings

- Moody's Investors Service, a publisher established in 1900, stole the idea for ratings from Dun & Bradstreet in 1909 to enhance the value to investors of his statistical manuals
- Fitch Investors Service established 1913; ratings from 1924
- Standard Statistical and Poor's Corp merged in 1923
- Rating agencies' strength is derived from the credibility and reliability of their opinion and research
- Since 1985, entrepreneurs, IFC and governments have sponsored the formation of about sixty agencies

# What Are The Market's Needs?

- A reliable third party opinion on the likelihood that an issue/issuer will repay its financial obligations in timely manner, i.e. not default
- A reliable third party opinion regarding an insurer's financial strength and the insurer's ability to meet contractual obligations
- Assessment of the level of compliance with principles of Shari'a
- Assessment of an entity's practices to assess the demarcation of rights and responsibilities of different stakeholders and compliance with prevailing rules and procedures for making decisions

**Sovereign Ratings  
and Credit Ratings**

**Insurer's Financial  
Strength Ratings**

**Shari'a Quality  
Ratings**

**Corporate  
Governance Ratings**

# Principal Benefits of Rating - Issuers

- Enhances access to capital and funding, often influences pricing
- Places the name on the “credit map” (globally-understood symbols)
- Exposes an issuer’s management to best practice
- Assists with diversification of investor base
- Means of communicating creditworthiness to key counterparties
- Internal management tool to assist financial and strategic planning
- Enhances the transparency of financial market players
- Facilitates secondary market liquidity
- Assists in bringing efficiency and stability in the financial system
- Ratings can bring clarity to a bank’s status as a counterparty

# Principal Benefits of Rating - Investors

- A primary tool to use in investment decisions
- Expert analysis can provide useful insights
- Research reports reflect independent opinions
- Over time, investors and Investment Account Holders will come to rely on ratings
- Reduce information asymmetry by providing an independent opinion on an issuer's risk profile
- Provide a qualitative and quantitative analysis forecasting future net free cash flow and relative payment capacity
- Provides an appropriate pricing framework for the market

# Principal Benefits of Rating – Intermediaries

For fund arranger (Bank/ Investment Bank/ Underwriters) the benefits are predicated on:

- Objective and informed third party opinion on the credit strengths and weaknesses of the subject entity/ issue
- Meeting of internal guidelines in some institutions that require rating as pre-requisite for any investment or syndication or credit facility
- In the case of Sukuk, rating will ensure greater liquidity and marketability by facilitating risk based pricing
- The rating report provided by the rating agency contains detailed credit analysis which promotes transparency
- The rating scale with unambiguous definitions is well understood by the market and creates comparability



# Principal Benefits of Ratings - Regulators

- **Common Objectives of Regulators**
  1. Containment of risks
  2. Sufficiency of disclosure
  3. Protection of less sophisticated investors
  4. Limiting the possibility of fraud
- **Enhanced analytical capacity in the market**
- **Quality framework to guide risk pricing**
- **Often, early warning on developing problems**
- **May assist in framing suitable regulations**

# Role of Rating Agencies

- Reduce asymmetry in information
- Provide objective, professional independent opinion in simple code
- Maintain high standards of professionalism to earn confidence among investors



# Stage of Development of Islamic Capital Markets

- Important players are GCC countries, Malaysia, Indonesia & Pakistan
- Equities market developed to a respectable size
- Debt market relatively new and developing
- Sukuk market showing rapid growth
- IFSB, AAOIFI, IIRA contributing to development of capital markets



# Efficient Capital Market

- Allows disintermediation of banking sector
- Reduces reliance on banking sector for funding needs for large issuers
- Usually reduces costs of funds
- Affords diverse avenues for liquidity management
- With rating infrastructure, aligns funding cost to risk profile of borrower
- Credit Ratings accelerate development of capital market



# Some Regulatory Requirements in South & South East Asian Countries

- Compulsory rating of banks
- Compulsory rating of Sukuk and certain other debt instruments
- Minimum rating benchmarks for companies issuing certificates of deposits and certificates of Mudharabas
- In Bangladesh, IPOs must be rated



# The Need for developing a Rating Agency in this Region?

*“Development of credit rating agencies..... is a key institutional reform to help develop corporate and sub-sovereign bond markets, as well as asset-backed securities markets...”*

**- Observations by International Monetary Fund (IMF) in Financial Sector Assessment: A Handbook**

**In the Constituent General Assembly of IIRA, His Excellency, Dr. Ahmed Mohamed Ali, President of IDB stated:**

*“The establishment of IIRA is a cornerstone of the Islamic banking industry...The first aim to be achieved in relation to IIRA is to receive recognition of it from bodies and institutions concerned with control and management of money markets throughout the world and in particular central banks...”*



# Shari'a Compliance

- Central pillar of Islamic financial institutions
- Is a continuous process
- Requires independent monitoring



# Islamic International Rating Agency

- The “Ten-Year Framework and Strategies” for Islamic Financial Services Industry Development includes establishment of a Rating Agency. In line with this strategy, Islamic Development Bank (IDB) took steps to establish IIRA in 2002
- Other participants included well-known banks from different countries and two rating agencies
- IIRA has many Sponsors ensuring IIRA’s independence and avoiding dominance
- IIRA started its operations in late 2005, and is now recognized by Central Bank of Bahrain as an ECAI
- IIRA is generating awareness of ratings in the region
- Volume of inquiries is growing
- IIRA has been voted the Best Islamic Rating Agency in 2006 according to a poll conducted by Islamic Finance News



# What is an IIRA Rating?

An independent, objective opinion regarding the relative capacity to meet financial obligations, including Islamic returns

## IIRA's Ratings are NOT:

- Recommendations to buy, sell or hold
- A guarantee against loss
- An Audit

## IIRA's Definition of Default

- An issuer's failure to meet its obligations on time



# IIRA's Competitive Advantages

- The management of IIRA consists of experienced professionals, from different countries, with in-depth knowledge and experience
- IIRA's target regions include: GCC countries, Other Islamic countries in Middle East and North Africa, South Asia, and Far East
- IIRA employs international best practice
- IIRA is the only agency based in the region
- IIRA has superior regional knowledge that results in superior conclusions
- IIRA is the only agency that offers Shari'a Quality Rating (SQR)
- The value model for IIRA rests on investors and lenders use of ratings and the quality of supporting research



# IIRA's Competitive Advantages - *Cont'd...*

- IIRA is completely independent and transparent, follows a consistent methodical and rigorous analytical process and subscribes to a code of conduct/ethics which is consistent with the IOSCO code of conduct for rating agencies as well as Basel II
- Rating Committee: IIRA's Rating Committee consists of core members plus occasional experts. All Rating Committee members are completely independent and have no conflict of interest with the entity or instrument to be rated
- IIRA's website [www.iirating.com](http://www.iirating.com) makes full disclosure regarding its ownership, management, rating methodology for all its services and rating scales and definitions



# IIRA and Basel-II ECAI Requirements

1. Objectivity – IIRA has rigorous and systematic methodologies; Assessments are subjected to ongoing review; IIRA maintains records for Backtesting, its ratings and transactions
2. Independence – IIRA is fully independent and not subject to political or economic pressures; Assessment process is free from any conflicts of interest emanating from the Board of Directors or shareholders
3. International access/Transparency – The assessments are available to both domestic and foreign institutions



# IIRA and Basel-II ECAI Requirements

4. Disclosure – IIRA’s assessment methodologies including the definition of default, the time horizon and the meaning of each rating are publicly available; Actual default rates experienced in each assessment categories and the transition of assessments are being maintained
5. Resources – Sufficient resources to carryout high quality credit assessments are available; Ongoing contacts with senior and operational level within the entities assessed are maintained
6. Credibility – is being gradually built up derived from above criteria; and supported by existence of internal procedures & standards



# IIRA's Recognition as ECAI by CBB

المدير التنفيذي للرقابة المصرفية

Executive Director - Banking Supervision



مصرف البحرين المركزي

Central Bank of Bahrain

You letter of 12<sup>th</sup> February covers the six eligibility criteria and your reasons for why you believe that IIRA satisfies these criteria. I confirm that IIRA is recognised by the Central Bank as an External Credit Assessment Institution (“ECAI”). There are some points in relation to the above criteria where I would appreciate your comments going forward and which we may wish to discuss with you when we make our next periodic reassessment of ECAIs.

## A. Objectivity

The methodologies outlined by you appear to be rigorous and systematic, however your website shows no methodology (as yet) for commercial entities. Will you be releasing such a document soon, and would you please forward a copy for our reference? Second, would you please outline how you will be back-testing your ratings as time progresses.



# Committee of European Banking Supervisors (CEBS) Guidelines on the Recognition of ECAI

Two modes of supervisory recognition are set out in the Capital Requirements Directive (CRD) of CEBS:

- Direct Recognition: supervisors make their own evaluation of an ECAI's compliance with the recognition criteria
- Indirect Recognition: supervisors recognize an ECAI based on recognition in another Member State, without carrying out their own evaluation process. This can be a valuable instrument for enhancing efficiency and reducing administrative burdens
- Following the above indirect approach adopted by CEBS, a GCC country should recognize a rating agency as ECAI based on recognition by another GCC country



# IIRA's Mission and Services - I

The mission of IIRA is to foster development of the financial markets in which it operates through provision of:

- Ratings for Sovereigns
- Traditional bond/Sukuk Ratings and Rating framework to permit rational pricing
- Insurer Financial Strength Ratings
- Shari'a Quality Ratings to reflect institutional compliance
- Issuer Ratings
- Specialist, focused Corporate Governance Ratings
- Real Estate Project Ratings
- IIRA provides ratings for all types of issuers and issues



# IIRA's Mission and Services - II

- A periodic summary bulletin of market activity and ratings
- Economic commentary from a credit and investment quality perspective
- Detailed rating reports to enhance the investment decision process
- Sector reports clarifying company status within industry groupings
- A record of actual and prospective money and capital market activity
- Analysis of financial institution counterparty risk for treasurers
- Seminars on the analytical principles employed by rating agencies



# IIRA's Shareholders

IIRA has in its shareholding group:

## **A. Multilateral Finance Institutions**

1. Islamic Development Bank (56 members, Headquarters Saudi Arabia)
2. Islamic Corporation for the Development of the Private Sector, Saudi Arabia

## **B. Rating Agencies**

1. Capital Intelligence Ltd., Cyprus
2. JCR-VIS Credit Rating Co. Ltd., Pakistan
3. Malaysian Rating Corporation Berhad, Malaysia

## **C. Banks and Insurance Companies**

1. Kuwait Turkish Participation Bank Inc., Turkey
2. Bahrain Islamic Bank B.S.C., Bahrain
3. Arcapita Bank B.S.C., Bahrain
4. Abu Dhabi Islamic Bank, United Arab Emirates
5. Takaful Malaysia, Berhad, Malaysia



## **IIRA's Shareholders - *Cont'd...***

6. First Investment Company K.S.C., Kuwait
7. Pakistan Kuwait Investment Company (Pvt.) Ltd., Pakistan
8. Arab Islamic Bank, Palestine
9. Dubai Islamic Bank, United Arab Emirates
10. Bosna Bank International, Bosnia
11. Al-Baraka Banking Group, Bahrain
12. Jordan Islamic Bank, Jordan
13. Bank Islam Malaysia Berhad, Malaysia
14. Dubai Bank, United Arab Emirates
15. International Leasing & Investment Company, Kuwait
16. A.K. Bakri & Sons (Bermuda) Ltd.



# **Key Analytical Approaches to Different Types of Ratings**



# **IIRA's Sovereign Rating Analysis**



# IIRA's Sovereign Rating Analysis

- IIRA evaluates the creditworthiness of the government of a country, determining its ability and willingness to fully service its financial obligations on time.
- IIRA provides its sovereign ratings on following scales
  - Local Currency International Scale
  - Foreign Currency International Scale
  - National scale
- IIRA has documented policies to account for country risk represented by country's sovereign ratings in all the ratings assigned to issuers within a country
- IIRA's sovereign ratings on national scale helps issuers to avoid the rating compression that they face due to low international scale rating of the country



# IIRA's Sovereign Rating Analysis

IIRA's sovereign analysis for all countries is comprised of a set of fundamentals. These are

- Politics and Policy Continuity
- The Economy—Structure and Growth Prospects
- Budgetary and Fiscal Policy
- Monetary Policy and Flexibility
- The External Accounts
- Internal and External Debt



# IIRA's Sovereign Rating Analysis

- The analytical framework conforms with the standard global best practice. Additionally as a regional rating agency focused on the emerging market economies IIRA possesses insight in the regional markets and specifically the political and social environment
- Our sovereign ratings as a result reflect the true potential of the emerging market economies. In the case of Bahrain we arrived at a higher ratings compared to the global rating agencies and subsequently global rating agencies issued upgrades for the Kingdom vindicating IIRA's stance
- In the case of Turkey, based on the high potential in the economy backed by a maturing and gradually improving political system, IIRA has announced higher ratings for the Republic compared to global agencies. Turkey has achieved extraordinary progress in the last seven years, largely in terms of sound economic and financial management leading to completion of IMF led structural reforms, significant lowering of the debt burden relative to GDP, shifting much of the government's external debt to a domestic basis, gaining control of inflation, and broadening the export base.



# IIRA's Bank Rating Analysis

IIRA provides two scales of ratings:

National (Domestic)

International

- These scales remain same whether the bank rated is a conventional bank or an Islamic bank





# The Basic Question

- Investment quality and/or creditworthiness is the issue.
- Banks of all types face the same conundrum: will the customer pay what he has agreed to pay.



# The Rating Framework

Bank analysis in all countries is comprised of a set of fundamentals:

- **Market assessment**
- Asset Quality evaluation
- Liquidity and funds management
- Asset/Liability management
- Capital adequacy
- Adjustments to achieve economic reality
- Finance, information systems, planning disciplines
- Earnings Performance
- Ownership and management performance



# Market Assessment

- Size and character of economy
- Market diversification
- Growth patterns
- Regulatory oversight
- Competitive position
- Nature of competition



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# Evaluating Asset Quality

- The Banking Environment
- Credit or Investment Policies
- Loan Administration Procedures
- Portfolio Composition and Characteristics
- Risk Management Practices
- Lending History and Performance
- Forecasting the portfolio and quality
- Analytical conclusions regarding economic values



# The Banking Environment

- Basic demographics of the market
- Entrepreneurial bent of human resources
- Natural resources and infrastructure
- Stage of industrial development
- Penetration of small business
- Needs and profile of the consumer market
- Prevalence of large industrial concerns



# Credit or Investment Policies

- Mission statement
- Management structure, training, control
- Separation of client marketing & credit functions
- Clear identification of decision process
- Stipulation of lending authorities
- Targets of portfolio distribution
- Customer limits set against capital
- Loan matching and risk based pricing
- Participations and purchased loans
- Management of investment credit risk



# Loan Administration Procedures

- Monitoring and review responsibilities.
- On-going file maintenance requirements
- Frequency of information distribution
- Monitoring lending limits of the individual officers
- Exception reports
- Rectification time limits
- Procedures for classification of loans
- Confidentiality of information



# Portfolio Composition and Characteristics

- IIRA will survey bank's own credit policies as a first step
- Information needed is quite detailed and goes beyond the published reports
- A significant concentration is defined by IIRA as 5% or more of equity
- Actual data presented by bank is then organized to analyze the distribution of the portfolio by industry, customer type and markets
- Element of segmentation is the identification of portfolio sectors that are susceptible to actuarial analysis
- Valuable tool for IIRA is our knowledge of the credit experience of others in the market



# Risk Management Practices

- Conservative and realistic limits are key to risk management
- Administration of loan must be separated from lending department
- Credit classification works best when it is assigned as part of origination process to an independent credit bureau or analytical department
- Once the loan has been granted, booked and funded, the hard part begins : collecting the loan



# Risk Management Practices (Cont'd)

Risk management has a very important element which is credit review. This includes

- Monitoring payment performance
- File maintenance review
- Credit analysis
- Alerting lending officers to sector developments
- Reclassification of customer facilities as condition deteriorates



# Lending History and Performance

- Implementation of credit policies
- Industrial and sector diversification over time.
- Avoidance of customer concentrations
- Actual loss experience
- Treatment of problem loans
- Reserving and write-off practices observed
- Accounting for impaired assets
- The asset book today



# Forecasting the Portfolio and Quality

- The nature of market
- Portfolio of other banks competing in the market.
- In most instances, bank will continue to doing what it knows how to do
- Existing portfolio is the basis for determination of future credit policies and loan administration procedures
- Nature of market and adherence to policy will result in loan losses that are either predictable or erratic
- Significance of loan concentrations by industry and customer
- Rapid growth in loans is a key risk indicator
- IIRA expects the same policy for interbank placements and investment activities



# Analytical Conclusions Regarding Economic Values

- Impairment in asset values
- Focus on cash generated from the asset
- Principle of conservatism
- Asset valuation and expectations
- Affect on cash flows
- Adjusting capital



# The Rating Framework

Bank analysis in all countries is comprised of a set of fundamentals:

- Market assessment
- Asset Quality evaluation
- **Liquidity and funds management**
- Asset/Liability management
- Capital adequacy
- Adjustments to achieve economic reality
- Finance, information systems, planning disciplines
- Earnings Performance
- Ownership and management performance





# Liquidity and Funds Management

What we do to make that judgment:

- Stratify the deposits by type, maturity and size
- Look at the proportion between current and term accounts
- Real demand for overnight funds is different than the technical
- Analysis of term accounts in terms of maturity, and history of withdrawals
- Analysis looks at preponderance of hot money
- Proportion of liquid assets in portfolio

There is no magic formula to determine whether the bank employs the optimal mix of liabilities to fund the balance sheet













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# Strategic Planning, Budgeting and MIS

Strategic planning is a crucial indicator of management capacity. Effective banking begins with comprehensive knowledge of the market.

There are several things to understand

- The heart of franchise value is customers. Who are they ? Where are they ? What are their needs.
- Bank must have clear understanding of competition and opportunity to create USP.
- The bank's distribution channels must be fully understood.
- Technology must be in place to support electronic and POS delivery
- Management Information system must be recent enough to give comprehensive information.
- Budgeting must accurately reflect the expenses and capital investment to get the market share.





# Earnings Performance

Income statement is the report card on bank's achievements in the analytical areas discussed in the presentation.

- However it too often fails to accurately reflect economic reality.
- IIRA resets income and expense categories to derive net interest income or its Islamic equivalent.
- Other fee based income is added to determine effective income.
- IIRA then deducts operating expense to derive a core profit number to serve as the basis for forecasting future performance.



# Earnings Performance (Cont'd)

Several revenue items are excluded, which are

- Fair value adjustments to write-up assets to presumed market value
- Trading and dealing profits on proprietary book are excluded
- May be necessary to adjust for deferred taxes in some environments
- IIRA adjust core profits for required asset quality adjustments and measures the derivative capital formation



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# Evaluating Ownership and Management

Key tools for assessing management are

- Performance
- Organizational structure
- Collegial style of management
- Strategic planning
- Budgeting / Variances
- Information system and reporting
- Market Outlook
- Rating Agency View



# The Rating Framework

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# **IIRA's Insurer's Financial Strength Rating Analysis**

## **Analyzing Insurance, Takaful and Retakaful**

**“Tie up your camel first, then put your trust in God”**



# Principles and Definitions I

- Muslim business practices focus on Justice, Equality, Ethics, Fairness and Morality
- Takaful originates from the Arabic verb Kafalah meaning joint guarantee
- Its characteristics include risk sharing and profit sharing.
- In principal, takaful is not sold, but participation is invited
- No interest (riba) is paid or may be received in the investment portfolio
- Uncertainty (gharar) is not permitted



# Why IFSR?

- Specialized – focus on the industry
- Useful for investors in the industry
- Guide for responsible regulators
- Captures the spectrum of insurance businesses
- Most important: reflects and compares claims-paying capacity.
- Does NOT reflect willingness to pay claims



# The Analysis

- The market and regulatory environment
- The industry
- The company
- From the general to the specific
- The value model and differential advantage
- Effective market discipline



# Definitions

- Premiums
- Contributions
- In force
- Reserves
- Density
- Penetration



## **Premium:**

- An insurance premium is the actual amount of money charged by insurance companies for active coverage.
- The cost of an insurance premium is largely based on statistics, not necessarily on individual habits or history.

## **Contribution:**

- A contribution is the Islamic term equivalent to Premium. Due to the nature of Takaful Insurance the proceeds collected are referred to as contribution rather than a premium, still it can be defined as the actual amount of money charged by Takaful companies for active coverage.



## **In force:**

- The dollar amount of life insurance that a company has issued measured as the sum of policy face values and dividends paid.

## **Reserves:**

- The amount of funds or assets necessary for a company to have at any given time to enable it, with interest and premiums paid as they shall occur, to meet all claims on the insurance.
- The reserve is always reckoned as a liability, and is calculated on net premiums. It is theoretically the difference between the present value of the total insurance and the present value of the future premiums on the insurance.



## Density:

- Insurance Density = Insurance Premium/ Population
- Insurance density is a measure of payments on insurance cover per capita. The higher the density ratio, the greater the demand for local currency annuity assets such as bonds. This indicator is normally paired with an insurance penetration indicator.



## **Penetration:**

- Insurance Penetration = Insurance Premium / Annualized Nominal GDP
- Insurance penetration ratios measure the level of insurance market development relative to the size of an economy. An increasing insurance penetration ratio indicates that the industry's asset size is growing.



# Principles and Definitions II

- Cannot sell or transfer risk; only sharing risk is permitted
- No gambling (maisir) or speculation is permitted
- Investments exclude forbidden industries like alcohol or pork production
- Risks are shared among participants
- Takaful companies become the participants in retakaful to further mitigate risk
- Islamic finance – what is a default? Default is failure to meet the terms of an agreed commitment



# Ratings and Takaful Companies

- For customers and investors – claims paying and credit ratings
- For the takaful company – ratings and research on its investments
- For prospective customers and company management – Shari'a Quality Ratings



# Takaful Structures and Business Models

## Typically two components:

- An Operator, which manages the underwriting and investments
- The takaful fund to which participants pay their premiums or contributions

## Operator, depending on the arrangement is compensated in various ways

- **Wakalah (Agency)**

The operator administers the pool funds derived from the participants, paying claims and investing excess amounts. For this, the operator receives an agreed fee

- **Mudarabah Model**

In this case, the operator is mudarib under a contract which specifies how profits are shared, or losses borne. Usually, the participants, as capital providers, bear any losses



- **Combination**

Arrangements sometimes include a wakalah agreement for managing the business plus a mudharabah contract detailing a split on investment profits achieved

- **Waqf Model**

Shareholders of a takaful operator cede a portion of capital to serve as the base for the takaful fund, in this case called the waqf fund. Management of the business then is typically on an agency (wakalah) basis

- **Cooperative Model**

This model merges shareholder capital and the takaful fund in a way incorporates shari'a compliant obligations on the part of the different stakeholders



# Analytical Issues

**Key issues IIRA considers in its analysis include:**

- The Market for Takaful products
- Structures and implications
- Products/The promise and value model
- Shari'a compliance
- Investment alternatives/determinants of risk
- Management/Scholars
- Staffing and Training
- Financial and accounting characteristics
- Capital metrics and performance



# The Market for Takaful

- Data are limited
- An estimated 1.5 billion Muslims are prospects for participation
- Others may find the products and pricing attractive as well
- Aggregate contributions estimated at less than \$3 billion, less than 1% of global insurance premiums which are more than \$3.7 trillion
- Takaful contribution growth rates now exceed 15% annually



# Structures and Implications

- In a pure mutual or cooperative structure, the policy holders appoint the managers of underwriting and the investment managers. With policy holder control, the interest of managers and insurers must be congruent
- The interests of Takaful Operators and Participants may diverge
- Takaful Operators may not benefit from mortality profits or investment earnings on the Fund
- Operators are responsible for underwriting shortfalls, which must be funded through qard' hasan
- Return of the qard' hasan is only theoretical and may not happen



# Products/The Promise and Value Model

- Takaful products pool and share risk, it does not transfer
- The promise is a return of contributions paid, and some additional amount predicated on a pre-determined share of other's contributions
- The value model rests on Shari'a compliance for Muslims choosing to honor the precepts, or on pricing advantage to others seeking family protection on an affordable basis



# Shari'a Compliance

- The most important distinguishing element for a takaful company is compliance with the rules of Shari'a in the design of its risk-sharing products
- It is also imperative the investment portfolios consist solely of Islamic products to ensure all returns can be viewed as legitimate by the scholars
- Compliance can be assured with policies and documentation approved by the company's board of Shari'a scholars



# Legitimate Investment Alternatives

- Most equity, which entails risk-sharing and profit-sharing, is suitable
- Certain categories of Sukuk pricing have been deemed acceptable in certain jurisdictions
- Real estate is often acceptable
- There is a scarcity of Islamic paper structured to be Shari'a compliant
- Investment returns and benefit to product pricing are therefore constrained



# Determinants of Risk

Traditional approach looks at

- Measuring future net free cash flow
- Hazard risk – what could go wrong?
- Control risk – what needs to be controlled or done to prevent error?
- Opportunity risk – what must go right?
- The severity of the impact and frequency of occurrence define importance



# Management/Scholars

- IIRA would expect close coordination between management and the Shari'a Scholars
- Governance mechanisms must ensure sustained congruence between Operator's and Participant's objectives
- Managers must have actuarial and investment skills



# Staffing and Training

- Takaful is effectively a new industry with relatively few expert practitioners
- For the most part, the pool of employment candidates must be trained to add value



# Financial and Accounting Characteristics

- Accounting governed by AAOIFI Standard 12
- Requires focus on Shari'a compliance
- Initial capital belongs to shareholders in the Operator
- Available to meet underwriting deficit
- Disposition of profits varies



# Retakaful

Growing numbers of participants and entrants

- More than sixty companies are active in takaful and retakaful
- **Examples:**
- Munich RE set up a retakaful branch in KL;
- Hannover Re established a retakeful subsidiary in Bahrain;
- Tokio Marine established Nichido Retakeful;
- Scottish Re entered the business.



# Expected Performance

- Challenges noted throughout this discussion are expected to be overcome
- Business written at the consumer level will grow with additional risk laid off
- Profits will improve as a result of expense control, reduced cession costs and better investment options
- More conventional insurance companies will organize retakaful operations



# IIRA's View of the Future of Takaful

- Takaful growth will exceed growth of other forms of Islamic finance
- Drivers of this growth will include:
  - Creation of new products;
  - Recognition of the value of coverage in under-insured markets;
  - Expansion of technical insurance capacity with a focus on takaful principles;
  - Ample resources can be found to overcome obstacles and challenges.



# Analysis

- Just to suggest, in closing, a few important elements of our analysis
- Three to five year pool history preferred
- Management performance and experience of the Operator
- Background and data defining target markets
- Growth in premiums (contributions) and coverage
- Loss experience and reserve development
- Combined ratio performance



# **Corporate Governance Ratings (CGR)**



# Importance of Corporate Governance

Corporate governance is considered important

- Better corporate management
- Better compliance
- As a social responsibility
- Improving reputation

**ALL TRUE BUT .....**



# **MORE IMPORTANTLY**

Corporate governance is considered important

- To lower cost of capital
- To enhance access to outside capital

## **I DO NOT BELIEVE IT**



# **Dr. Nasser Saidi, Executive Director, Hawkamah Institute of Corporate Governance in UAE**

Investors are willing to pay a premium of between 15-30% more in emerging markets for companies they perceive as being well governed so stock market value can be increased by \$200 – 300 billion in the GCC per year

Zawya, July 16



# **WHY THE REGION GENERALLY IS INDIFFERENT TO CORPORATE GOVERNANCE**



# **Dr. Nasser Saidi, Executive Director, Hawkamah Institute of Corporate Governance in UAE**

One major reason there hasn't been better corporate governance take-up from private businesses is that the region has yet to be hit by a cataclysm on the scale of the Enron collapse or the Asian economic crisis.



# Failures Due to Poor Corporate Governance

Too much power is centered on one individual without proper oversight... **e.g. Enron,**

Board fails to ensure controls are robust or question the unusual or the unrealistic ... **e.g. Barings**

Poor disclosure and transparency becomes commonplace ... **e.g. WorldCom**

Shareholder rights are mistreated... **e.g. Parmalat et al**



**Want to See More Recent Example**

**THE  
SOCIETE GENERALE  
FIASCO**



**Want to See Examples Closer to Home**

**THE RECENT  
HAPPENINGS IN  
REAL ESTATE OF  
UAE**



# Islam and Corporate Governance

‘O ye that believe! Betray not the trust of God and the Apostle, nor misappropriate knowingly things entrusted to you” (Al-Anfal: 27)



# **What is IIRA Corporate Governance Rating (CGR)**

Corporate Governance Ratings look at the practices of an entity to assess the demarcation of rights and responsibilities of different stakeholders and compliance with prevailing rules and procedures for making decisions.



# Essence of IIRA's CGR

The spirit of the methodology is to synthesize the key elements of Corporate Governance on a global basis and not to impose the standards of any particular country or jurisdiction. The aim is to ensure sufficient flexibility to accommodate different governance structures in the rating process without compromising the assessment of the entity's governance standards on the touchstones of fairness, transparency, accountability and responsibility.

# Why IIRA

- Corporate Governance should be an internal matter. This should be dealt by departments like compliance, audit

**WRONG**

**WHY**

- Corporate Governance is a more holistic concept. It should take into account each unit of the organization including Board of Directors
- Even then, the job can be done internally

**PARTIALLY TRUE**

# Why IIRA

## What IIRA brings to the table

- It is an independent, third party and is not being influenced by anyone in the market / industry / organization
- It has managerial experience of many years doing the rating business
- It has the opportunity to observe the practices of a number of institutions in the region and therefore is in a much better position to provide a competitive position

# Why IIRA

## What IIRA brings to the table

- It has a better understanding of the region, than the competitors, as it is located in this region and understand the culture and sensitivities of the region
- The IIRA provides its conclusions in a simple rating symbol which helps to create a healthy competition among the institutions



# Pillars of IIRA's CGR

- Regulatory Compliance
- Ownership structure
- Board Structure and Processes
- Management Structure & Processes
- Transparency & Disclosure
- Control & Discipline
- Stakeholders' Relations



# Corporate Governance Rating Methodology - Criteria

- **Regulatory Compliance**
  - Level of compliance with all applicable laws, listing requirements and rules of all regulatory, taxation and statutory bodies, including labor and environmental regulations
- **Ownership Structure**
  - Structure and breakdown of shareholdings and ownership rights and obligations
- **Board & Executive Management Structure & Processes**
  - Board and management composition, responsibilities and performance
  - Shareholder management relations



# Corporate Governance Rating Methodology - Criteria

- **Transparency**
  - Quality and timeliness of disclosure of adequate information
- **Control & Discipline**
  - Qualification and independence of internal and external auditors
  - Responsibilities and performance of the audit committees
- **Stakeholders' Relations**
  - Employee-employer relations, human resources management policies and practices and disclosure to code of business conducts and ethics
  - Entity's social responsibilities and customer relations



# IIRA's Corporate Governance Rating Definitions

- **CGR-10:** Strongest Corporate Governance processes and practices overall, with very few weaknesses in any of the major areas of governance analysis.
- **CGR-9:** Very strong Corporate Governance processes and practices overall, with few weaknesses in any of the major areas of governance analysis.
- **CGR-8:** Strong Corporate Governance processes and practices overall, with some weaknesses in certain of the major areas of governance analysis.
- **CGR-7:** Moderately strong Corporate Governance processes and practices overall, with weaknesses in certain of the major areas of governance analysis.
- **CGR-6:** Satisfactory Corporate Governance processes and practices overall, with some weaknesses in several of the major areas of governance analysis.
- **CGR-5:** Adequate Corporate Governance processes and practices overall, with weaknesses in several of the major areas of governance analysis.
- **CGR-4:** Moderately weak Corporate Governance processes and practices overall, with weaknesses in a number of the major areas of governance analysis.
- **CGR-3:** Weak Corporate Governance processes and practices overall, with significant weaknesses in a number of the major areas of governance analysis.
- **CGR-2:** Very weak Corporate Governance processes and practices overall, with significant weaknesses in most of the major areas of analysis.
- **CGR-1:** Weakest level of Corporate Governance processes and practices overall, with significant weaknesses in most of the major areas of analysis.



# Real Estate Ratings

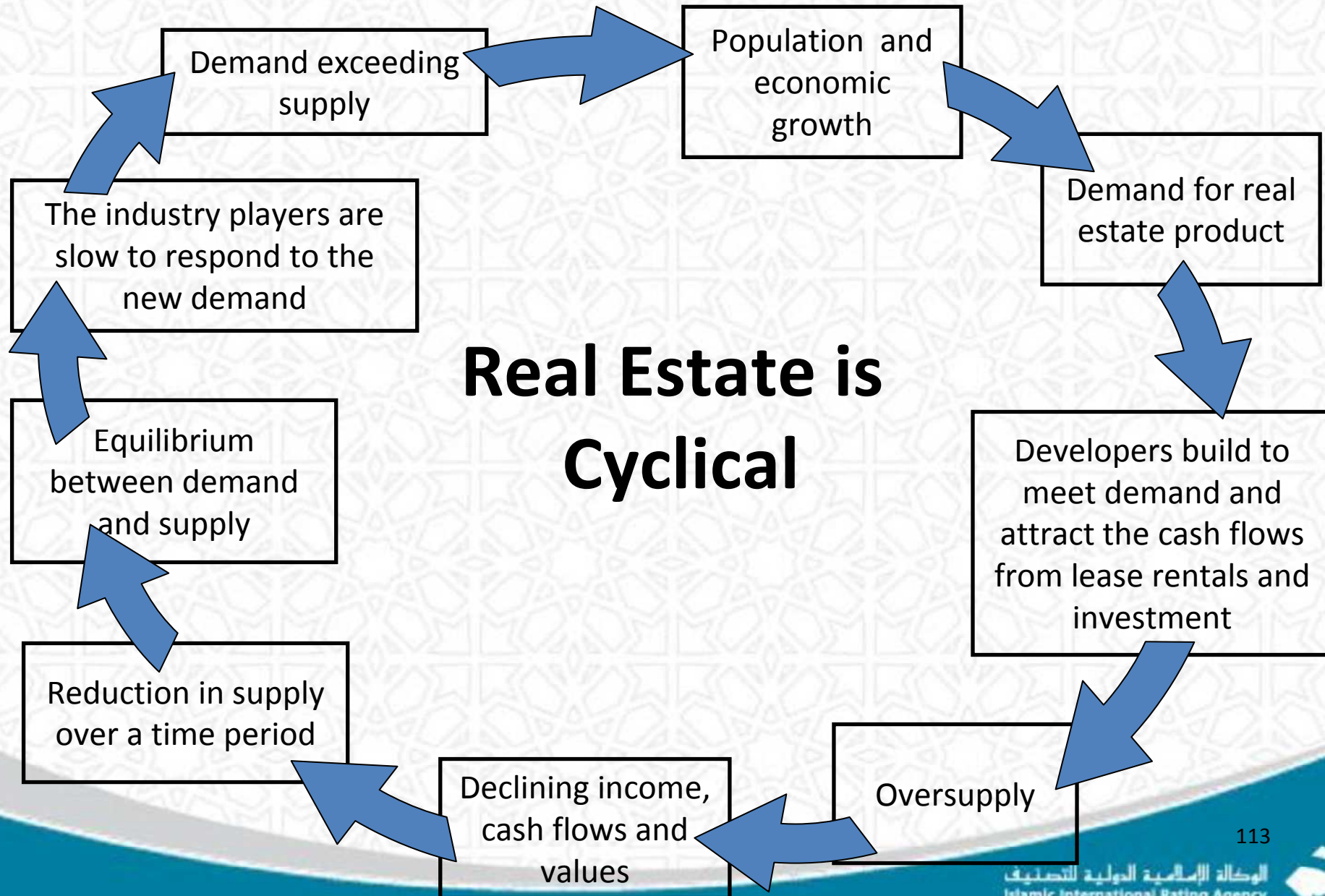


# Importance of Real Estate Industry

- Important and fast growing sector in the markets covered by IIRA.
- Represents a significant commitment by the investor.
- Catalyst for growth in a number of other industries.
- Fulfills one of important functions of Government i.e. Creator of Jobs



# Industry Dynamics



# What does IIRA's Real Estate Rating Methodology covers

- Although IIRA's RE Rating Methodology is primarily a developer rating methodology
- But .....



# Risk Analysis of Real Estate Industry

Risk Analysis is evaluated under three sections

- Industry Risk
- Developer specific risk
- Project specific risk



# Industry Risk

- Regulatory environment
- Nominal and Real GDP growth of the country
- Demographics
- Nature of business growth in the country
- Number of industry players and status of competition
- Real estate product inventories, occupancy and income
- Cost and Supply of raw material
- Status of construction activity
- Nature of new projects expected to be completed within next 2-3 years, additions to inventory
- Historical and projected absorption rate of new projects



# Developer Specific Risks

## A) Capacity Risk

- A.1) Legal Risk
- A.2) Past Construction History
- A.3) Reputational Risk

## B) Operational Risk

- B.1) Organizational Risk
- B.2) System Risk
- B.3 ) Strategy Risk
- B.4) Diversification Risk

## C) Financial Risk

- C.1. Existing Financial Profile
- C.2. Lack of financial flexibility



# Project Specific Risks

- Demand and Supply Risk
- Legal Risk
- Participant Risk
- Completion Risk
- Weather Conditions and other natural factors
- After –Sales Services / Maintenance Risk
- Financial Risk
- Likelihood of Time and Cost Overruns



# Beneficiaries of IIRA's Real Estate Ratings

## Real Estate Developers

- Tool to highlight their strengths in project execution and marketing
- Acts a benchmark for the industry
- Leads to a healthy competition
- Help in mobilizing institutional funds

## Banking, Financial and Lending Institutions and Investors

## Government and Regulators



# Shari'a Quality Rating



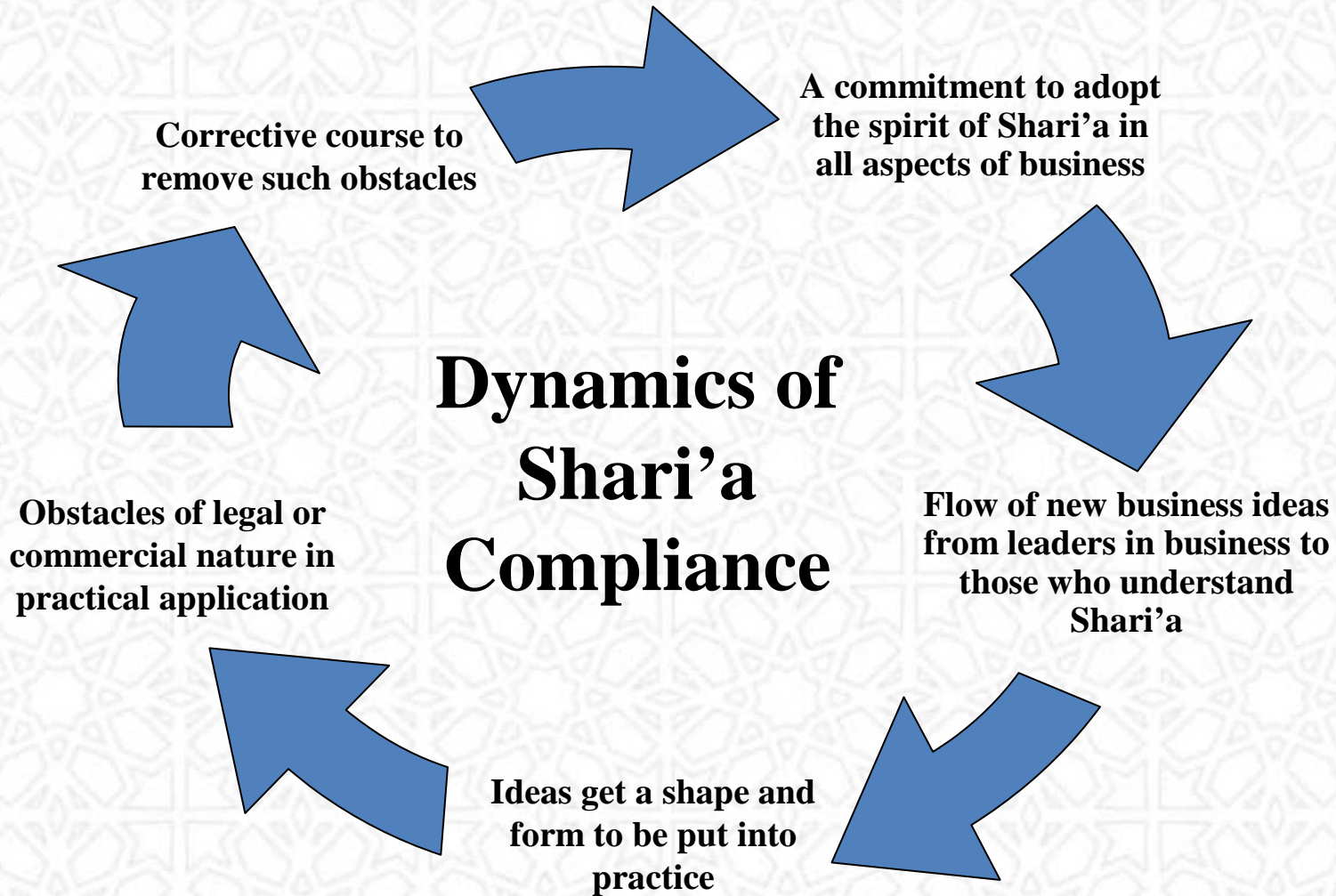
# Shari'a Quality Rating (SQR)

SQR is a transparent evaluation system ,based on objectivity, impartiality and independence, assessing the level of compliance by the institutions to the stipulations adopted by their Shari'a committees.

In general, SQR does not comment on the decisions of the Shari'a committees of banks and financial institutions



# Need for SQR



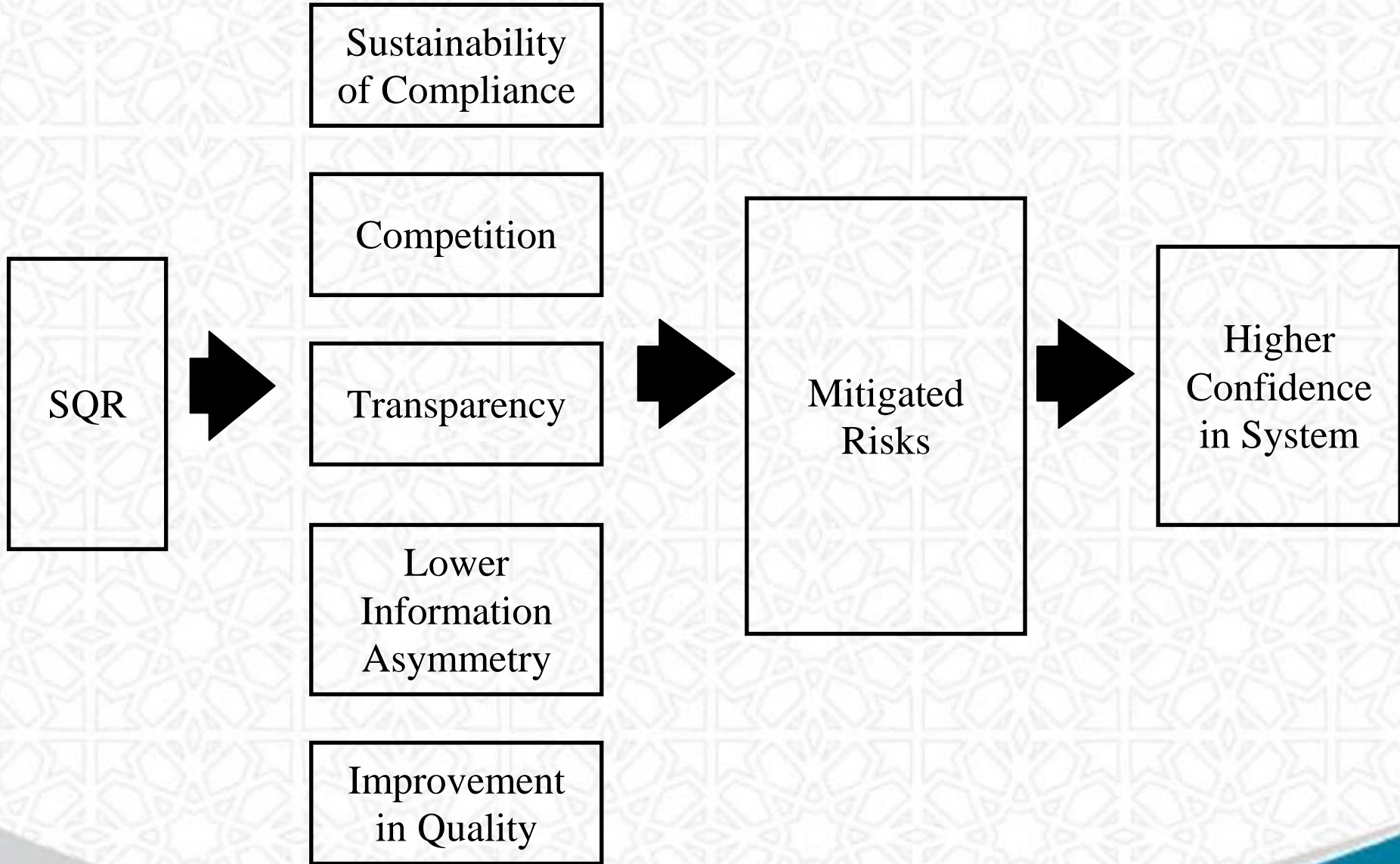
**Because of the dynamic nature of Shari'a compliance, all institutions cannot have the same level of compliance**



# Risks of Non-Shari'a Compliance

- Displaced commercial risk
- Loss of income
- Risk of non-sustainability of Shari'a compliance
- Risk of conflict of interest inherent in audit by SSB
- Institutions have different levels of Shari'a compliance and therefore different levels of exposure to above risks
- Shari'a Quality Rating mitigates the above risks





# Parties who benefit from SQR

- Management can improve Shari'a compliance practices to manage non-compliance risks
- Depositors and investors choose IFI for business to conform to their faith
- Regulators expect IFIs to meet regulations of compliance with Shari'a



# SQR Evaluation Criteria

- Shari'a Committee
- Internal Shari'a Control
- Accounting Standards
- Training and Human Resources
- Zakat
- Social Impact
- Modes of Financing
- Identity and Corporate Image
- Other considerations



# IIRA's Shari'a Board Scholars

1. Justice Muhammad Taqi Usmani, Pakistan
2. Dr. Abdul Sattar Abu Ghudah, Syria
3. Dr. Mohamed A. Elgari, Saudi Arabia
4. Dr. Layachi Feddad, Algeria
5. Dr. Ahmad Ali Abdullah, Sudan
6. Dr. Nazih Hammad, Canada
7. Sheikh Mohamed Ali Al-Taskheri, Iran
8. Dr. Hussein Hamed Hassan, Egypt
9. Dr. Sheikh Nizam Yaquby, Bahrain
10. Dr. Mohammed Daud Bakar, Malaysia
11. Professor Dr. Mohamed A. Al-Sherif, Kuwait
12. Dr. Abdulwahhab Al-Dailami, Yemen
13. Professor Dr. Abdul Salam Al Abbadi, Jordan
14. Sheikh Mohsin Hussien Al Asfoor, Bahrain
15. Dr. Mohamed Al-Habib Ibn Al-Khuja, Tunisia
16. Professor Dr. Ali Moheldin Al-Quradaghi, Qatar
17. Sheikh Abdullah Al-Manea, Saudi Arabia
18. Sheikh Khalil Al-Mais, Lebanon
19. Professor Dr. Abdulaziz Bayindir, Turkey



# FAQs

- **Is there any need for a Shari'a Quality Rating?**
- **How does IIRA's Shari'a Quality Rating respond to the need?**
- **How were the members of Shari'a Board of IIRA selected?**
- **How are the members of the Shari'a Committee of IIRA selected?**
- **Do you believe that Islamic ratings will see an increased demand to accompany the increase in demand for Islamic banking and insurance?**



# IIRA's Shari'a Quality Rating Definitions

- **AAA (SQR):** In IIRA's opinion, an entity/instrument rated AAA (SQR) conforms to highest level of standards of Shari'a requirements in all aspects of Shari'a quality analysis.
- **AA (SQR):** In IIRA's opinion, an entity/instrument rated AA (SQR) conforms to very high level of standards of Shari'a requirements in all aspects of Shari'a quality analysis.
- **A (SQR):** In IIRA's opinion, an entity/instrument rated A (SQR) conforms to high level of standards of Shari'a requirements and has very few weaknesses in some areas of Shari'a quality analysis.
- **BBB (SQR):** In IIRA's opinion, an entity/instrument rated BBB (SQR) conforms to moderately high level of standards of Shari'a requirements and has few weaknesses in some areas of Shari'a quality analysis.
- **BB (SQR):** In IIRA's opinion, an entity/instrument rated BB (SQR) conforms to satisfactory level of standards of Shari'a requirements and has some weaknesses in some areas of Shari'a quality analysis.
- **B (SQR):** In IIRA's opinion, an entity/instrument rated B (SQR) conforms to adequate level of standards of Shari'a requirements and has weaknesses in some areas of Shari'a quality analysis.



# **IIRA's Rating Process**

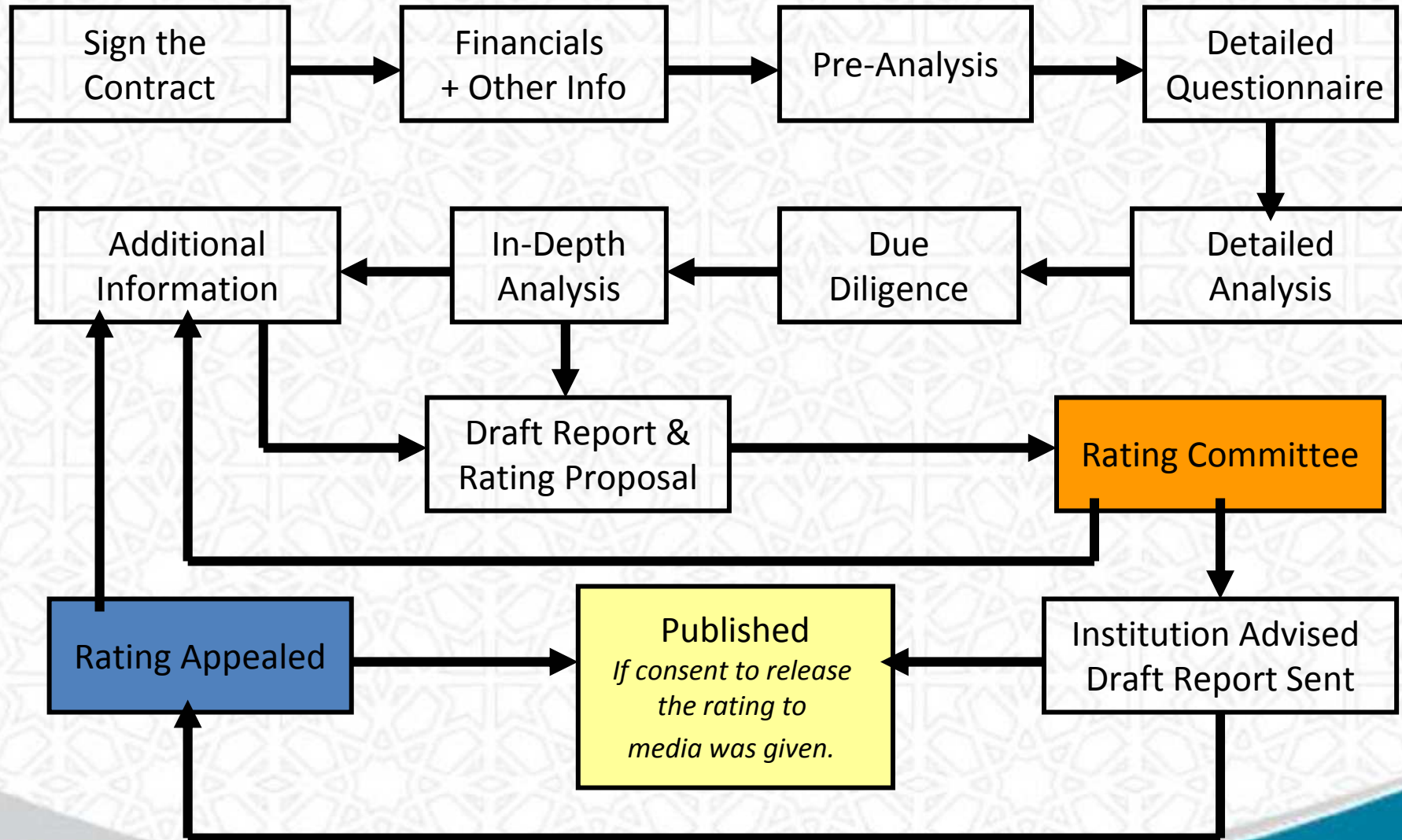


# IIRA's Rating Process

IIRA Rating Process	
<b>Issuer/Client</b>	1. Signs agreement for an initial rating
	2. Submits preliminary information materials
<b>IIRA</b>	3. Conducts a preliminary study
	4. Submits a detailed questionnaire to the issuer/client
<b>Issuer/Client</b>	5. Provides detailed information in response to detailed questionnaire
<b>IIRA</b>	6. Conducts pre due diligence meeting analysis
	7. Conducts due diligence meetings
	8. Conducts post due diligence analysis
	9. Brief for internal rating committee meetings is prepared
<b>Rating Committee</b>	10. Decides the preliminary/initial rating
<b>IIRA</b>	11. Notifies issuer of the preliminary/initial rating
<b>Rating Committee</b>	12. Deliberates on appeals by issuer/client and gives decision
<b>IIRA</b>	13. Notifies the decision of the Rating Committee to the issuer/client
<b>Issuer/Client</b>	14. Consents to release of the rating to the public
<b>IIRA</b>	15. Releases the rating to media



# IIRA's Rating Process



# Issuers' Rights & Obligations

## **Rights:**

- Confidentiality
- Right of non publication
- Right to appeal

## **Obligations:**

- Full and complete information
- Full cooperation with IIRA's team
- Inform IIRA about any significant event that have an impact on issuer's performance



# Post Assignment Monitoring of Outstanding Ratings

- Continuous Information Gathering
- Regular Contact with Issuers
- Rating Reviews
- Rating Changes
- Default and Transition Studies



# Information Requirements for Rating Applicants

- Information needed often goes beyond the published information
- IIRA does not insist on specific format in which information is to be provided
- Any format in which the institution MIS generates information is acceptable though illustrative data entry exhibits are provided to help client understand the information needs
- Strict confidentiality is maintained through out the rating process. The non public client data obtained at any stage of the rating exercise is subject to strict confidentiality



# Samples of information required

1. Annual Reports, preferably for the last five years
2. Interim reports for the last two years
3. A summary of current period performance as reflected in management reports.
4. Examples of recent market research employed in the planning process.
5. Individual financial statements for principal subsidiaries (balance sheet, income statements and cash flow statements) for the last two years.
6. Strategic Plans over the planning horizon, capital and operating budgets for the next two years
7. Ownership details, guarantees, lending or borrowing relationships



# Thank You

## Contacts

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