

# Standard & Poor's Approaches To Islamic Finance

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## Key messages

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- Standard & Poor's acknowledges that **the Islamic finance industry has come of age** and become part of the region's mainstream business architecture.
- **Standard & Poor's endeavors to support the fast development of the Islamic finance industry:** thought leadership and analytical excellence in the rating process also benefits Sharia-compliant issuers and investors. Our recent launching of a series of S&P Shariah Indexes also signals such a commitment.
- Standard & Poor's assigns credit ratings to Sharia-compliant issuers and issues, **irrespective of their identity or economic nature**, e.g. Islamic tranches in project finance.
- **The overall analytical methodology and criteria applicable in these cases do not materially differ** from those for conventional issuers and instruments... **but some specific adjustments, refinements, and criteria** have been developed to more adequately for specificities.

# Introduction

The universe of rated Sharia-compliant issuers and issues has expanded rapidly, since we started in 2002.

Issue Credit Ratings			
Originator	Date of first rating	Issue Amount	LT Rating (foreign currency)
Malaysia Global Sukuk Inc.	June 10, 2002	\$600 million	A-
Kingdom of Bahrain (sukuk notes)	Sept. 04, 2002	\$80 million	A
Kingdom of Bahrain (sukuk notes)	Nov. 11, 2002	\$50 million	A
Solidarity Trust Services Ltd. (Guarantor: Islamic	Aug. 11, 2003	\$400 million	AAA
Qatar Global Sukuk QSC	Sept. 10, 2003	\$700 million	AA-
Bahrain Monetary Agency International Sukuk Co.	Feb. 18, 2004	\$250 million	A
Stichting Sachsen-Anhalt Trust	July 9, 2004	€100 million	AA-
Loehmann's Capital Corp. (Guarantor: Loehmann's	Sept. 22, 2004	\$110 million	CCC+
Sarawak Corporate Sukuk Co.	Nov. 30, 2004	\$350 million	A-
Pakistan International Sukuk Co.	Dec. 23, 2004	\$600 million	B+
Gold Sukuk dmcc (Guarantor: Dubai Metals and	Apr. 11, 2005	\$200 million	A
Islamic Development Bank	May 20, 2005	\$1,000 million	AAA
East Cameron Gas Co. Sukuk	July 31, 2006	\$166 million	CCC+
Tabreed 06 Financing Corp	June 15, 2006	\$200 million	BBB-
Sharjah Islamic Bank Sukuk	Sept. 12, 2006	\$255 million	BBB
Dubai Islamic Bank Sukuk	Feb. 15, 2007	\$TBD million	A(prelim)
Issuer Credit Ratings			
Issuer	Date of first rating	Country	LT Rating (foreign currency)
Kuwait Finance House	Aug. 24, 2004	Kuwait	A-
Al Rajhi Bank	Oct. 5, 2005	Saudi Arabia	A
Islamic Development Bank	Dec. 19, 2002	Saudi Arabia	AAA
Gulf Finance House	Aug. 7, 2006	Bahrain	BBB-
Sharjah Islamic Bank	Sept. 06, 2006	United Arab Emirates	BBB
Dubai Islamic Bank	Oct. 18, 2006	United Arab Emirates	A
Shamil Bank of Bahrain	Nov. 6, 2006	Bahrain	BBB-
Arcapita Bank	Nov. 16, 2006	Bahrain	BBB
BEST Reinsurance Co	Sept. 2, 1997	Tunisia	BBB
Takaful Re Ltd.	Oct. 31, 2006	United Arab Emirates	BBB
Albaraka Banking Group	March 21, 2007	Bahrain	BBB-

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# Agenda

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- 1. The meaning of ratings for Islamic financial institutions**
- 2. Rating sukuk notes: S&P's dual approach**
- 3. Ratings and Sharia-compliance: is there an issue?**

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# 1. The meaning of ratings for Islamic financial institutions

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## **It's all about default after all...**

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- A default is defined as: **an obligor's incapacity or unwillingness to honor its financial obligations in full and on time.**
- **Islamic obligor's financial obligations fall under this broad definition of default.**
- However, given the various categories of a Sharia-compliant obligor's liabilities, **the identification of default might not always be straightforward...**
- ... All the more so as **the liability continuum of Islamic financial institutions (IFIs) differs from that of conventional banks**

# IFIs' liability structure

Assets	Liabilities
Pool of banking assets	Non-remunerated current accounts (qardh hasan)
	Short-term interbank and customer murabahas <b>Deposit-like liabilities</b>
	Long-term syndicated murabahas
	Sukuk notes
	Unrestricted profit-sharing investment accounts (PSIAs) <b>Specific liabilities</b>
	Profit equalization reserves
	Investment risk reserves <b>Equity liabilities</b>
	Shareholders' equity

## Non-remunerated current accounts (qardh hasan)

- Liabilities that **do not bear returns**, but are fully **guaranteed** by the Islamic bank.
- Underlying Sharia contract: **qardh hasan**.
- Default would be recognized on such non-remunerated sight deposits and current accounts if **the Islamic bank cannot pay back the full amount on request**, provided it is asked to do so by the depositor.
- Fall under the broader category of “**deposits**” for analytical purposes.
- **The issuer credit rating is the relevant measure of creditworthiness here.**

## Term deposits (short-term and long-term murabaha funds)

- Liabilities that **do bear returns**, and principal is also fully **guaranteed** by the Islamic bank. Maturities can vary: short-term asset-backed deposits are mainly a substitute for the conventional interbank market; long-term asset-backed deposits are mainly designed for corporate customers.
- Underlying Sharia contracts: short- and long-term **murabaha**. Underlying assets are often, if not always, liquid commodities. Technique: buy-and-sell commodity transactions with third parties, usually involving a broker and another bank.
- Default would be recognized on such term deposits if **the Islamic bank cannot pay back either the principal, or the predetermined mark-up, at the maturity of the deposit.**
- Also fall under the broader category of “**term deposits**” for analytical purposes.
- **The issuer credit rating is also the relevant measure of creditworthiness here.**

## Profit-sharing investment accounts (mudharaba/musharaka)

- Not deposits per se. **Hybrid liabilities displaying deposit-like and equity-like characteristics.** PSIAs are in particular **loss absorbing**, under the principle of profit and loss sharing between “musharikin”.
- Underlying Sharia contracts: **the combination of a musharaka and mudharaba contracts.** The musharaka component: PSIA-holders and shareholders commingle funds in the banking venture; the mudharaba component: the bank manages PSIA-holders funds on their behalf, and is thus entitled to be paid a commission for this service.
- **A negative return served to PSIA holders following a loss incurred by the Islamic bank would not be deemed equivalent to default.** There is no breach of contractual obligation.
- However, if **the Islamic bank fails to honor the terms of the PSIA contract, default would be immediately recognized.** Example: *at the maturity date attached to a \$100 PSIA, the latter is impaired by contractual losses of -\$10. If the banks pays back \$80 instead of \$90, breach of contract terms will be recognized as well as default.*

## Profit-sharing investment accounts: the need for a more specific focus

- PSIA deemed **non-ratable hybrid instruments**, as *“it would be practically impossible for Standard & Poor’s to monitor comprehensively and in a timely manner each and every PSIA contract to identify its contractual default, despite the standardized nature of many of these contracts”*.
- Although **PSIA cannot be eligible to issue credit ratings** from S&P, *“counterparties to a given IFI should refer to Standard & Poor’s **issuer credit ratings** to gauge the IFI’s overall creditworthiness, in the absence of issue-specific credit ratings on PSIAs”*.
- **This approach could be completed by a specific rating scale for PSIAs, i.e. stability ratings.** *“Stability ratings are current opinions on the prospective relative stability of distributable cash flow generation of income funds and IFIs’ PSIAs. Stability ratings refer specifically to the prospective relative sustainability and variability of an income fund’s or an IFI’s distributable cash flows”*.

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## 2. Rating sukuk notes: S&P's dual approach

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## Sharia-compliant asset-backed notes (sukuk)

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- Sharia-compliant securitized assets issued by sovereigns, banks and (increasingly) corporate entities. Two broad analytical categories: “**guaranteed**” (even partially) by the obligor Vs. **profit-and-loss sharing structures**.
- Underlying Sharia contracts: there are many ways to structure sukuk notes (sukuk al ijara, al murabaha, al mudharaba, al musharaka...). Most common structures: **ijara and musharaka sukuk**.
- The two broad analytical categories are treated from **two different perspectives for default recognition**: in the case of guaranteed sukuk, absence of guarantor’s timely action in case of insufficient asset cash flow for principal or coupon payment is default; for non-guaranteed sukuk (profit-and-loss sukuk deals), the same approach as for PSIAs would apply.
- Overall, a **case-by-case analysis** for rating sukuk is S&P’s preferred approach.

## **Sukuk issue-specific credit ratings: S&P's dual approach**

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- In broad terms, the analytic treatment of sukuk **distinguishes between non-profit-sharing structures** (“guaranteed” sukuk) and **profit-sharing ones** (more “equity-like” contracts).
- Applicable methodology for “guaranteed” sukuk: **same as those applied on conventional debt issuance**. Sukuk ratings would be equalized to the issuer’s/originator’s ones if payment obligations (e.g. lease and repurchase obligations in ijara sukuk) are “timely, irrevocable and unconditional”. S&P does not exclude the possibility of rating such sukuk “above the issuer’s ratings if the credit characteristics of the sukuk resemble those of secured debt”.
- Whenever such guarantees do not exist, typically for profit-and-loss sukuk structures, **the equity-like features of the sukuk prevail**. This is the case for mudharaba-based notes. Standard methodologies might not be applicable per se, and equalization with issuer’s/originator’s ratings might not be straightforward. In such cases, **structured finance criteria would better fit, as for securitization deals**.

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## **3. Ratings and Sharia-compliance: is there an issue?**

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## Is there an issue? The answer is “no”!

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- “*Standard & Poor’s does not pronounce on the **suitability of a particular obligation from the perspective of Sharia compliance**”.*
- “*One consideration in the rating, however, is the determination of the bond’s legal enforceability. S&P bases its rating opinion on the compliance of any transaction with applicable commercial law. (...) Accordingly, an **S&P rating does not address compliance with Sharia law as a matter of enforceability through commercial tribunals**”.*
- “***S&P does not review the role or composition of the Sharia board, nor does it opine on the validity of that board’s recommendations and decisions**”.*
- “*To the extent that [given] sukuk are governed solely by Sharia and are subject to the jurisdiction of Sharia courts, then a declaration by such courts that the sukuk do not comply with Islamic law could render sukuk unenforceable. **This eventuality would, of course, be factored into the rating**”.*
- **In a word: the Sharia-compliant nature of sukuk is neutral from a credit perspective in most cases. However, legal as well as Sharia documentations and opinions are less straightforward, and deserve close scrutiny.**

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## Conclusions and expectations

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## Concluding remarks

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- Standard & Poor's has been **leading credit research and analysis in Islamic finance** for half a decade.
- We expect **the Islamic finance industry to continue its spectacular growth** in the foreseeable future.
- **Some challenges remain though for the whole Islamic finance industry**: conceptual fragmentation; consistency across geographies; market liquidity; innovation and human resources.
- **Ratings will continue to be extremely useful for issuers of Sharia-compliant notes** from various perspectives: transparency; access to regional and international liquidity; fair pricing; and regulatory as well as compliance requirements.
- Standard & Poor's is **well equipped to provide more ratings to Sharia-compliant issues and issuers** going forward.

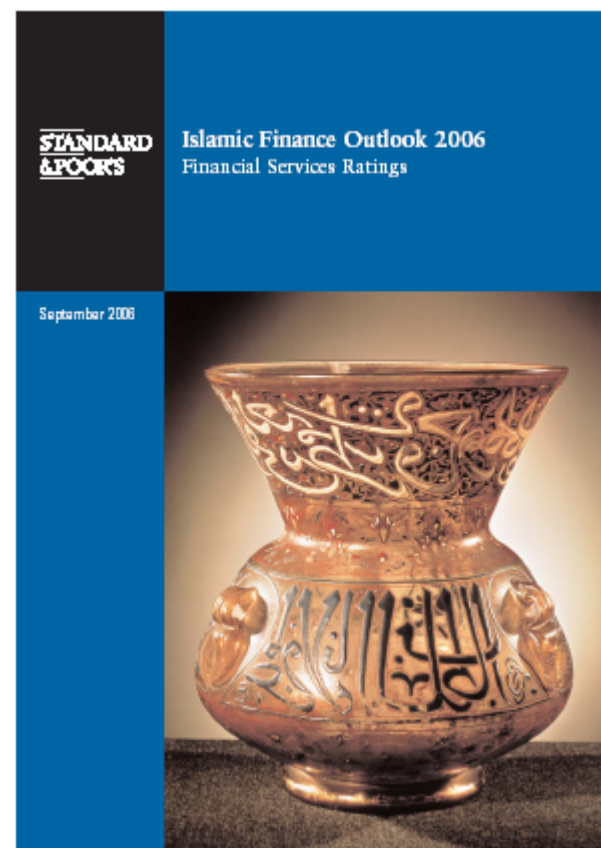
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