



## THE SUKUK MARKET AND ROLE OF RATINGS

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Sukuk as an Islamic Financial Instrument has become an important avenue for raising finance from the capital markets. It is widely used by sovereigns, financial institutions and corporates. Number and volume of Sukuks have been steadily growing since 2001. While the financial crisis had an impact on Sukuk issuances in 2008, the market recovered very quickly, with higher 2010 numbers; the trend continues and Sukuks issued in 2011 have already exceeded the 2010 figures. For 2012, the expectations are much more optimistic. A number of sovereigns along with financial institutions and corporates are expected to tap into the Sukuk market.

Currently, in terms of volumes and issuances, the two major centers in the Sukuk market are Malaysia and GCC. Out of the 2000+ Sukuks issued in the last 10+ years, around 66% were issued in Malaysia while 30% were issued in GCC. In terms of volume, Malaysia accounted for 63% of the Sukuks with GCC's share placed at 30%.

The composition of the Sukuk market within these two centers varies as to the profile of the issuers. In Malaysia, out of around 1,300 Sukuks issued, approx. 27% are by Sovereign / Quasi Sovereign while 73% are by corporates. The mix is entirely different in the GCC where the share of sovereign / quasi sovereign issuers is 74% while corporates have only 26% share. Even within corporates, a large number of Sukuk issuances in GCC are by financial institutions compared to Malaysia where it is spread across different economic sectors.

Beside the variety in the economic profiles of the two regional centers, an important feature distinguishing the two is the stage of development of the rating culture. In GCC, it is not mandatory for an issuer to go through the rating process for the issuance of Sukuk, with the result that only 20% of the issues have been rated. In contrast, in Malaysia it is mandatory that all local currency issues are rated by at least one domestic credit rating agency.

We believe that if the GCC regulators also adopt the same model as of Malaysia by mandating ratings for all Sukuks, it will contribute significantly to the development of a broad based debt market.

Ratings essentially provide stacking of risk profile of investments available in the market by credit risk. The role of ratings is to enhance transparency and efficiency in debt markets by reducing the information asymmetry between borrowers and lenders. In turn, ratings may also facilitate pricing in line with underlying risks. Through the rating process, small and medium businesses may also be introduced to the market as rating symbols are fairly standardized and understood by the financial community at large.

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## FIDUCIARY RATINGS CAPTURE ESSENCE OF ISLAMIC FINANCE

The evolution of Islamic Finance as a parallel to conventional finance has gained significant global recognition in the past few decades. IIRA recognizes Islamic finance as fundamentally different from conventional finance. Recognizing the need to capture the unique dimensions of Islamic Financial Institutions (IFIs), IIRA, together with its technical partners and shareholders, JCR-VIS Credit Rating Company of Pakistan and the Malaysian Rating Corporation, has developed the Fiduciary Rating (FR) methodology.

FR is a two-dimensional rating product. In contrast to conventional ratings that focus either on credit or governance aspects, the FR recognizes the mutually dependent nature of credit and fiduciary risks in an IFI. The presence of a sound governance structure does not guarantee strong financial performance and fiduciary scores may be faced with downward pressure on account of credit related developments, despite the absence of any negative developments on the fiduciary front. Poorly governed institutions may, however, be more susceptible to the risk of failure.

FR consists of two broad pillars: Credit Rating and Fiduciary Score.

### **Credit Rating**

The Credit Rating assessment is focused on the ability and willingness of an institution to meet its contractual obligations in a timely manner. It must be recognized that in the case of IFIs, the nature of liability in various modes of financing differs. For Profit Sharing Investment Accounts (PSIAs), the failure to meet the terms of the contract will be construed as default, i.e. if the bank pays an amount that is less than what is due after adjusting for profit or loss, if any, the bank is considered to be in default. The IFI is not obliged to bear all losses unless the losses are a result of misconduct or negligence on the part of the Mudarib or entrepreneur. For other liabilities, such as Amanah accounts, the terms of the contract require payment in full of the invested amount.

### **Fiduciary Score**

The analytical framework for Fiduciary Score has been developed to accommodate the unique features of IFIs and jurisdictional differences in Shari'a standards. The aggregate Fiduciary Score is derived from three elements, which are:

- Corporate and Shari'a Governance (including transparency and disclosure)
- Compliance with Shari'a Principles
- Asset Manager Quality

**Corporate and Shari'a Governance:** The governance structure in an institution is the result of the interaction between the shareholders, i.e. Rab-al-Mal, the Board of Directors and the Management (which acts on behalf of the shareholders). The form of ownership structure also has a bearing on the way governance is conducted in an organization. The Shari'ah Board is an additional supervisory body, which assumes significant importance in an IFI. Timely provision of information and transparency in disclosures is considered an overriding necessity.

**Compliance with Shari'a Principles:** An important obligation that distinguishes an IFI is the requirement for engaging and investing in businesses that are Shari'ah-compliant and in accordance with the directives from the institution's own Shari'ah Guidance System. A Shari'ah compliance score serves to provide an independent judgment on the degree of compliance with these precepts. This would include compliance with Shari'ah requirements with respect to product design and development, legal documentation and

processes. Shari'ah non-compliance can affect the earning potential and, more importantly, an institution's franchise value.

**Asset Manager Quality:** An Islamic bank's role is far greater than simply that of a borrower and lender. The IFI also invests funds made available by PSIA holders, just as an asset manager would. IIRA believes that the business acumen of the IFI's management and their ability to manage a wide range of investment mandates and asset classes are fundamental to the IFI's performance as an asset manager. This capability translates into the ability of the asset manager to return Amanah in its entirety and preserve the value of investment of PSIA's, against foreseeable and manageable risks (mostly un-systemic risks like business risks, etc). This is regardless of the fact that the IFI may not be contractually liable to ensure that the principal investment of PSIA's does not experience any degree of erosion.

As detailed above, the FRS caters to all stakeholders. It will appeal to the Shari'ah conscious investors, who wish to compare institutions in terms of their ability to remain compliant with internal Shari'ah rulings, as well as PSIA holders who are concerned with an IFI's potential to safeguard the value of their investments. At the same time, it will assess the ability of the institution to manage business in a way that all liabilities are met in a timely manner to the extent that their specific contracts require.

We, at IIRA, believe that the Fiduciary Ratings capture the nature of Islamic finance better than ever before.

#### TURKEY WORKSHOP

IIRA, in collaboration with the Union of Arab Banks (UAB), conducted a three day specialized workshop from October 12-14 in Istanbul, Turkey on the subject of 'Credit Rating and Analysis Instruments of Islamic Financial Institutions'.

The workshop was sponsored and hosted by Al Baraka Turk Participation Bank. The three day intensive workshop covered all facets of financial institution analysis including impact of sovereign risk and operating environment, qualitative and quantitative factors impacting risk profile of financial institutions, risk management framework and differences between conventional and Islamic financial institutions.

The workshop was attended by more than 24 participants from various countries including Turkey, Egypt, Palestine, Sudan, Lebanon and Iraq who came from diversified backgrounds including regulators and practitioners.



Participants of the workshop organized in Istanbul, Turkey

#### WORLD ISLAMIC BANKING CONFERENCE 2011

Islamic International Rating Agency (IIRA) together with its technical partners JCR-VIS Credit Rating Company Limited (JCR-VIS) of Pakistan and Malaysia Rating Corporation Berhad (MARC) organized a rating workshop at the 18th World Islamic Banking Conference held on November 21-23, 2011 in Bahrain. At the workshop, IIRA introduced its latest offering under the name of Fiduciary Ratings. The speakers emphasized that rather than adapting conventional thinking to accommodate Islamic finance, the methodology rethinks the risks in Islamic institutions, and is centered on the belief that in an IFI the quality of business being done is as important as the manner in which it is being done. As a result, a comprehensive system, integrating the principles of governance and the ability of an institution to safeguard the investment of its key stakeholders, has emerged with a special focus on Shari'ah governance. At the same time the methodology covers the ability of the institution to meet liabilities, simultaneously catering to all types of investors and all needs of any stakeholder in an IFI.

The introduction of the rating was followed by a presentation from a senior executive of Burj Bank Limited in Pakistan. The bank, having a significant shareholding by Islamic Corporation for Development of the Private Sector (ICD), is the first institution rated under this methodology. The speaker referred to the methodology as being extremely thorough and groundbreaking in its approach and the bank is expected to gain real benefits from the detailed rating report compiled by IIRA. This was followed by presentations by MARC and JCR-VIS which were focused on how ratings have contributed to development of alternate markets in emerging economies in recent times, resulting in stabilizing economic systems and broad basing risk opinions. This has led to increased trading and efficient price discovery in these markets. The speakers mentioned that that is the way forward for the GCC where debt markets are still in infancy. Tax incentives and development of primary and secondary market infrastructure along with strengthening of information dissemination channels like rating agencies will be instrumental to achieving the goal of developing capital markets in GCC.



Participation of the workshop held at WIBC, Bahrain