

3rd Kuala Lumpur Islamic Finance Forum (KLIFF)
24 - 29 November 2006

Organized by
Association of Islamic Banking Institution Malaysia (AIBIM) and,
Center of Research and Training (CERT)

Rating and Governance for Islamic Financial Institutions (IFIs)

By Jamal Abbas Zaidi, CEO
Islamic International Rating Agency, Bahrain



الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

Rating and Governance for Islamic Financial Institutions (IFIs)

- **Rating of IFIs follows a process similar to conventional institutions with assessment of IFI specific characteristics**
- **Our discussion will cover the analytical process for rating of conventional entities and additional factors specific to Islamic Financial Institutions**



Rating process comprises

- **Risk identification and mitigants covering the risk**
- **Benchmarking and evaluating with respect to peers across sectors and geographical locations**

Risk identification is done following a top to bottom approach

- **Determining risk profile vis-à-vis Global, Country and Industry level**
- **Risk Positioning- determined through ‘MIRACLE’ Approach**
- **Miracle stands for Management, Information System, Reputation & Resources, Asset Quality, Capital, Liquidity and Earnings framework**

In our following discussions we will elaborate above mentioned approach and highlight specific factors that need to be analyzed additionally for Islamic Financial Institutions



Country & Industry Analysis

- **Economic Analysis focuses on economic growth and stability, monetary policies, diversity in economy, level of corruption, and the size of private sector to evaluate prospective risks inherent for an institution to operate in a country**
- **Legitimacy of political regime, efficiency of legal system and reform agenda are evaluated to assess political environment**
- **Industry analysis focuses on the life cycle of industry and competing forces**
- **Regulatory environment covers licensing, capital regulation, other prudential regulations, supervision and independence of central bank**
- **For an Islamic Financial Institution additional factors to be considered are regulators' support for Islamic modes of Financing, the incentive/disincentive to Islamic Banking in the economy, and the presence of separate set of rules governing Islamic Financial Institutions and assurance of level playing field for Islamic Institutions**



Management

Rating process entails assessment of

- **Management quality which includes, mission and vision, competence, performance and track record, adherence to code of corporate governance best practices, internal controls, experience in crisis management, planning & budgeting procedures**

To rate an Islamic financial institution following additional factors are to be considered

- **Extent of knowledge & awareness of Shari'a by the top management**
- **Management commitment to adhere to shari'a laws in letter and spirit**
- **Fiduciary responsibility (contractually the depositors in IFIs may be passed on losses and therefore the Mudarib Bank has the responsibility to act in a prudent way to avoid such a situation)**
- **Fair dealing/ Transparency- In sharing profit and loss a transparent process should be in place which takes care of all stake holders' rights**



Information Systems

The evaluation process assesses

- **Management commitment for providing information technology resources for service quality up-gradation**
- **Existing resources (human and monetary) committed to achieve technological sophistication**
- **Planned capital expenditure related to acquisition of new technology**
- **Evaluation of information system is similar for Islamic and conventional institutions however when evaluating an Islamic entity it should be analyzed that the system is flexible enough to accommodate constantly evolving Islamic financial products**



Reputation & Resources

Reputation for a conventional financial institution means public perception of the institution, which is built upon

- **adherence to international best practices for corporate governance**
- **The level and probability of support of other groups & government in times of crisis**
- **Franchise value of the bank**

For an IFI reputation is even more important since

- **Adherence to shari'a principles in letter and spirit attracts customer loyalty from a large segment of investors/ depositors who want shari'a compliant products for investments**
- **A perception of lack of, or selective adherence to, Shari'a principles can repel or alienate the target customer base with long term damaging consequences**



Capital

- **Capital is required to act as safe guard against probable losses to which a financial institution is exposed to and to ensure the unimpaired ability of the bank to meet its financial obligations**
- **Basel II accord measures capital adequacy as a function of quantified risk arising from a financial institutions' credit, market and operational risk exposures**
- **Unfortunately no single consensus regulatory regime yet governs Islamic financial institutions. IFSB, however, has issued standards but these need acceptance by all the IFSB member countries for becoming a uniform regulatory regime**
- **For an Islamic financial institution level of capital should be sufficient to protect/ cover not only credit, market and operational risk but also commercial risk (i.e. risk of withdrawal in the event of loss or less than adequate return to investment account holders)**



Asset Quality

- **Asset quality is assessed using a variety of indicators which include**
 - **A negative trend or significantly increased risk in any area or product line**
 - **Deterioration in quality of credit portfolio**
 - **Rapid asset growth funded by volatile large deposits**
 - **A large size of off-balance sheet exposure**
- **Asset quality is also assessed using portfolio composition and concentration, composition of NPLs, allowances for loan losses and their adequacy, age of non-performing loans, loan follow up procedures and recoveries**
- **Market risk in trading book is quantified and analyzed using value at risk methodologies. VAR is a measure of maximum probable loss in market value of a portfolio at a predetermined confidence level and a target horizon**



Asset Quality (..contd)

In an Islamic financial institution risks vary from product to product therefore Asset Quality is further analyzed with respect to following aspects

- **Murabahah, usually the largest component of the asset, exposes the bank to payment delays and there is no recourse to mitigate that risk**
- **At commencement a Murabahah contract is also exposed to market risk**
- **In Ijarah mode of financing rent rate can be altered as a recourse for IFI however it carries the market risk on the asset until disposal**
- **Musharakah and Mudarabah are equivalent to equity transactions exposing the IFI to heightened asset risk (such as impairment, decline in market value, decline in yield etc.)**
- **However Islamic banks have the advantage of higher level of collateralization compared to conventional banks since most of the transactions are asset backed and can be converted into real assets**



Liquidity

- **The ultimate cost of liquidity is to be out of business**
- **Liquidity Management is the key factor that will determine the ability of an institution to honor its obligations**
- **Liquidity analysis is performed using combination of ratios and qualitative criteria; focus of analysis is to**
 - **gauge the balance sheet structure and determine the extent of diversification of assets and liabilities**
 - **analyze the funding mix, determine the natural funding level**
 - **evaluate the mismatches and determine the additional cost to manage liquidity in times of crisis**
 - **evaluate the reliance on wholesale funding sources to manage liquidity**
 - **determine reliability of recourses (such as loan sale, stock of tradable liquid assets and contingency funding plan) available to an institution in times of crisis**



Liquidity (Contd.)

For an Islamic Financial Institution liquidity management is even more important since they face a number of problems that are not faced by conventional banks, such as,

- **non existence of an efficient secondary debt market which may hamper liquidity of Islamic debt instruments (even though some countries are witnessing emergence of Islamic secondary debt market)**
- **reliance on lender of last resort, which is always central monetary authority, is limited and possible only if the central bank provides shari'a compliant funding support**
- **Islamic banks' assets (financing portfolio) are generally not saleable in secondary market**
- **Islamic banks generally use commodity Murabahah in a limited way to manage their liquidity**



Earnings

Earnings stability & diversification depends upon;

- **Contribution of core business to the bottom line profit. Core business is defined as basic lending and borrowing business**
- **Contribution of commercial and retail business to core earnings (we consider these to be more stable compared to corporate and treasury)**
- **Diversification of earning streams from various business lines (financing, investments and services)**
- **The structural balance in re-pricing of assets and liabilities; if there is a large mismatch then earnings might fluctuate as result of market movements**
- **For an Islamic financial institution the remuneration to the investment account holder should vary in line with market movement to avoid commercial risk of withdrawals. In the event of bank concentrating its financing portfolio in fixed/ predetermined return yielding assets (such as Murabahah), its earnings will not vary in line with market movements. This risk is factored in while assessing the financial strength of an institution**



Shari'a Compliance

- We have so far discussed financial rating of an Islamic financial institution. IIRA also analyzes an IFI from Shari'a compliance and corporate governance perspective using different parameters and rating scales
- For Shari'a compliance we look at the following aspects
 - Shari'a committee composition, appointment, meetings
 - Shari'a committee relations with management and importance given to its reports
 - training program in Islamic finance
 - identity and corporate image
 - treatment of non-Shari'a income
 - detailed structure of asset/ liability products/ schemes, to ascertain their compliance with Shari'a
 - compliance of agreements with the Shari'a approved documents
 - disclosure of relevant information
 - conformance of the code of ethics to Shari'a



Corporate Governance

- **For assessment of corporate governance our analysis covers the following major components**
 - **Regulatory compliance**
 - **Ownership structure**
 - **Board structure & processes**
 - **Executive management structure and processes**
 - **Transparency**
 - **Internal control and discipline; and**
 - **Stakeholders' relations**



Thank You

Contact Details

Jamal Abbas Zaidi
Chief Executive Officer
Islamic International Rating Agency

Telephone: +973 17211606

Fax: +973 17 211605

Email: jamal.zaidi@iirating.com

Webpage: www.iirating.com

Address: P.O. Box 20582

Manama

Kingdom of Bahrain

