Economy Islamic finance

Regional ratings: KNOWING THE NICHE

In a region where the necessary numerical data are not so forthcoming for rating purposes, an emphasis on the less tangible aspects is not only more important but also demonstrates a rounded rather than mechanistic approach to the process. Nasir Ali Merchant, Acting CEO of the Islamic International Rating Agency (IIRA), explains the essence of a specialist regional business compared to the international benchmarks

Please describe the background and rationale for IIRA's formation. How does your rating scale and its parameters compare with those of the international rating agencies?
IIRA was established in Bahrain to meet the need for an impartial, independent and reliable credit rating to help regional investors and other stakeholders. The shareholders of IIRA include Islamic Development Bank, Islamic Corporation for the Development of the Private Sector and Al Baraka Banking Group, along with a number of commercial banks and others, totalling 22.

IIRA provides ratings for all types of issuers and issues, for conventional and Islamic institutions, including sovereigns, credit ratings, Sharia Quality Ratings, sukuk ratings, insurer's financial strength ratings, corporate governance ratings and real estate project ratings.

While we are a fully-fledged rating agency providing ratings to all kinds of issuer and issues, the main focus is on institutions providing Sharia-compliant products and services.

IIRA has done ratings in the Middle East, North Africa, West Africa, Asia-Pacific and subcontinent Asia. Our methodology and rating symbols are the ones used internationally by other rating agencies. However, what makes us unique is the in-depth understanding of the region and expertise in Islamic finance.

A number of factors are taken into consideration depending on the nature of rating required. A significant weight is given to qualitative factors, because IIRA believes that most of the time those are the ones that shape the quantitative side of an institution.

While there are constraints in terms of the quality of publicly-available data — in particular as to the qualitative part — that is mitigated by comprehensive and in-depth meetings with the relevant officials of the ratee institution.


Nasir Ali Merchant

“A significant weight is given to qualitative factors, because IIRA believes that most of the time those are the ones that shape the quantitative side of an institution.”

Nasir Ali Merchant
Acting CEO, IIRA

In addition to the prior economic downturn, how has political turmoil in the Mena region impacted IIRA's ratings? Western agencies are often criticised for being behind the times. How often are your ratings reviewed?
There are two sides to the story.

One is to react to the situation and start rating adjustments, which most of the rating agencies do by downgrading/upgrading the rating, changing the outlook, or both at the same time. Rating agencies also at least put the rating on a watch list of the particular sovereign/financial institution/corporate. This is not incorrect, as it is the responsibility of the rating agencies to inform the stakeholder about the current position of the ratee.

However, the rating agencies also take a more holistic approach by taking into account the more long-term implications of the current situation and in light of that reaching a conclusion whether those events are one-off or the beginning of a series of events.

While you may be right that sometimes rating agencies are criticised for being behind the times, we also have to balance against a jumping-the-gun kind of thinking.

During the past couple of months IIRA has internally taken an in-depth look at the events unfolding and has accordingly adjusted its ratings whenever required. All the ratings of IIRA are current, and reviewed on a consistent basis by the relevant analyst.

Can you comment specifically on the assessment of corporate governance in the rating process?
IIRA puts special emphasis (and significant weighting), on the assessment of corporate governance because, as already said, [it] and the qualitative factors are the ones that shape the quantitative side.

The principal factors considered in IIRA's corporate governance review include transparency and disclosure, board of directors' performance, executive management performance, efficiency of the organisational structure and support of the shareholders. We look for a governance framework that leads to a full, accurate and timely disclosure about all the material matters of the corporation — including but not limited to its financial performance and outlook, ownership and governance.

In addition to the usual ratings, we also offer a specific corporate governance rating wherein the emphasis on other factors — such as financial performance and equity — is minimal and only corporate governance factors themselves are taken into account. IIRA believes that this particular rating service is important for the Mena region, which for one or more reasons is perceived to be weaker in this area than other regions.

As for the standard of corporate governance, Mena may be behind other regions, but in the past five to ten years significant progress has been made, and most of the regulatory institutions have taken proactive steps in inculcating a strong governance culture. Most of the regulators have issued a code of corporate governance that is now reflective in the disclosures of institutions.

We believe that a lot of work still needs to be done, [but] the encouraging thing to note is that both regulators and financial institutions are taking a proactive approach.

The same may not be said, however, for the corporate sector, particular the publicly-listed corporate. One reason could be the limited influence of capital markets [in] the region, where a lot of funding requirements are still achieved through banking channels or by private equity. However, with the passage of time, as has happened in other regions, the local capital markets will become broader, and the listed institutions, under the influence of regulators, will implement a more comprehensive governance mechanism in their institutions.

Please explain how the analysis of risk of Islamic institutions and Sharia-compliant products differs from that of conventional issuers/issues. How about a perceived lack of standardisation in this respect?

I will divide this question into two parts: one is the process of issuing the judgment, decree or fatwa by the religious scholars, and the second is the mechanism through which this fatwa is implemented.

For the first part, a religious scholar reaches a conclusion based on his education and understanding of the Quran, Sunnah and other areas. IIRA does not get involved in that part, as this is neither its jurisdiction nor its area of expertise. We thoroughly believe that the religious scholars only give a fatwa based on their honest and independent assessment of the situation or the question that has been put.

> "As for corporate governance, Mena may be behind other regions, but in the past five to ten years significant progress has been made, and most of the regulatory institutions have taken proactive steps in inculcating a strong governance culture."
>
> Nasir Ali Merchant
> Acting CEO, IIRA

For the second part, IIRA, being a responsible member of the Islamic finance industry, has offered a specific rating we call Sharia Quality Rating (SQR). The methodology of this rating and the rating scale were approved by the Sharia board of IIRA, which comprises well-respected scholars of Islamic finance.

In broad terms SQR considers a number of factors, such as the quality of a Sharia committee, the effectiveness of internal Sharia control, the accounting standards being followed, training and human resources mechanisms, zakat calculation and distribution, social responsibility fulfilment, percentage, direction and strategy of participatory modes of financing, and the Islamic identity and corporate image of the organisation [being reviewed].

In areas of risk analysis, IIRA goes through the whole spectrum of risk issues that a conventional institution faces while assessing an Islamic finance institution.

However, in addition to that, we look also at its Sharia compliance procedures, which are explained above, as well as the particular risk arising out of Sharia compliance — like, for example, inventory risk which arises in some particular contracts wherein an Islamic finance institution has to buy a commodity from one party and then independently enter into another contract to sell that commodity to another party.

Another example is that of the additional operational risk that arises in some contracts in which the transaction steps have to be done in a particular order, failure of which would make the transaction null and void.

As for the said lack of standardisation, sometimes that is blown out of proportion. A lot of products are generally standardised over the globe, and a large number of religious decisions are also in conformity with one another. There would always be some difference of opinion, but we believe it is not as much as is [claimed].

A lot of work has already been done on the standardisation front, with the initiative taken by infrastructure organisations such as International Islamic Financial Market (IIFM), Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

Islamic finance, compared to its conventional counterpart, is still an infant industry, and standardisation of products will continue to evolve over time.■

Interview by Andrew Shouler, Editor, Financial Review