



Thank you very much for inviting me to discuss these very important topics of rating Islamic Financial Institutions. I will begin my presentation by sharing with you our perspectives from which we rate Islamic Institutions.

- **Economic, Financial and Investment Quality**
- **Shari’a Compliance**
- **Corporate Governance**

Before I start my discussions on these perspectives, let me give you a brief overview of comparisons between IFIs and conventional banks. Unlike conventional banks which operate on predetermined return sharing agreement with deposit holders that guarantees them principal and fixed rate of return, IFIs operate with profit sharing agreement with their depositors. The profit sharing agreement exposes the deposit holders to the loss of principal which IFIs are not legally obligated to indemnify. IFIs are expected to follow higher standard of morality and ethics and hence they are expected to forgo profit opportunities that involves a compromise on these core values. This may not be the case with conventional institutions, though over time increasing corporate and social responsibilities awareness is gradually neutralizing this difference. The accounting and regulatory standards are evolving and variations are observed across countries in the manner the financial information is presented. These differences play an important role in rating of Islamic Banks.

## **CREDIT RATING OF IFIs**

### **MARKET ASSESSMENT**

Market assessment starts with external analysis, focusing on potential for growth and stability of the country in which IFI is operating. It depends



**“Rating Methodologies for IIFS and Islamic Financial Instruments”**

*By: Jamal Abbas Zaidi*

upon a number of economic and socio-political factors affecting public lives.

The economic policies of the government are analyzed with the help of monetary and fiscal policies, diversity of the economy, reforms agenda, pace of economic liberalization, size of the private sector; are some of the considerations.

Political situation is analyzed with reference to level of harmony among various ethnic groups, Govt’s approval domestically and abroad, strength of the legal system and the government’s social reform agenda.

Industry strengths and weaknesses are analyzed. The analysis incorporates competition, pricing power, ease of entry/ exit, industry life cycle stages and threat of competing products.

Regulatory environment is instrumental in providing IFIs a level playing field against conventional counterparts. This is analyzed by looking into the rules governing taxation, licensing, capital and reserve regulations, prudential regulations, supervision and independence of central bank.

The extent of regulators’ support for Islamic modes of Financing and Incentives/ disincentives for Islamic Banking in the economy is also assessed to make sure that IFIs are not at a competitive disadvantage. The presence and adequacy of separate set of rules governing Islamic Financial Institutions and assurance of level playing field for Islamic finance are some of the elements that provide favorable operating environment for the IFIs.



### **Credit and investment policies and loan administration**

Credit policies and loan administration procedures should be documented. The document should clearly outline the lending rationale, criteria and the process which should be followed for approval of a credit facility. The document should delineate the management structure and control features in the credit origination process. Credit origination comprises of due diligence, approval, disbursement, monitoring and follow up. The document should provide for separation of authorities for marketing and approval. Credit policy guidelines should also include comprehensive structure that should establish limits on geographical, customer, product and industry concentrations.

The policy document is worthwhile only if it is enforced. It's strength lies in the importance that senior management attribute to it. This will be evident in protocols to ensure compliance, monitoring and review processes.

The credit risk in the investment portfolio is of sizeable significance since the Sukuk issuance is increasingly becoming preferred source to secure long term funding by big businesses in the middle-east and countries where Islamic Finance is rapidly emerging.

The Islamic characteristics of the Islamic products add unique dimensions to the risk profile of the IFIs. It is essential that the risks be precisely and unambiguously understood and the method to monitor and control them is clearly delineated. Murabaha is usually the largest component of assets. It exposes the bank to payment delays and market risk at initial stages.



The presence and efficacy of mitigating tools to counter above risks is analyzed.

In Ijarah mode of financing rent rates can be flexible as a protection against interest rate movements for IFI, however it carries the market risk on the assets until disposal.

Presence of skills to identify and manage high asset price risk involved in Musharaka and Mudaraba (contracts similar to equity investments) is analyzed.

We look at the contracts of various Shari'a compliant transactions to assess the risk that the IFI is exposed to.

The review of credit policies and loan administration is not a conclusive proof of soundness of the bank unless it is well demonstrated in the existing portfolio position on grounds. The information required to establish the asset quality parameters is quite extensive and in most of the circumstances it goes beyond what is published by the bank in its periodic financial statements. The exhaustive review checks all the asset quality indicators and employs a variety of tools and ratios to assess the soundness in the portfolio position and composition.

### **Risk Management Practices**

Sound risk management practices call for holistic approach to risk management. This should take into consideration the exposures that arise in all the activities of the bank. The most common risks that are applicable to both conventional and Islamic institutions are credit,



**“Rating Methodologies for IIFS and Islamic Financial Instruments”**

*By: Jamal Abbas Zaidi*

market, liquidity and operational risks. In addition to these an IFI is also exposed to displaced commercial risk and fiduciary risk.

The risk appetite should be set by the board at the strategic level. This is done after taking into consideration the organization’s business objectives. The asset allocation decision is part of strategic planning process. The allocation is consistent with the management expectation of the performance of each asset category that the bank wants to invest in. It is fair to expect a greater risk limit allocation for the areas which are expected to generate a high proportion of the bank’s earnings. The budgeting and planning process is carefully analyzed to assess this.

The methods used to measure, monitor and control the risk are also very important. These range from sophisticated VAR methodologies to plain vanilla position limit structures. There are a variety of techniques available to analyze the risk and choice of method is not important as much as the validation of the system in use is. If the system is validated using back testing techniques and it is conservative enough then it will suffice irrespective of the technique used.

Development of risk management systems and practices needs strong determination by the Management. Implementation requires establishing checks and balances in the system that prevent line manager from over stepping their authorities when taking business decisions. The inherent conflict of interest in their desire to meet the business targets on one hand and to stay within the risk limits on the other always provides a challenge. This can be controlled with the help of independent watch dog or risk



control unit. The unit should report directly to the board committee on risk management through Chief Risk Officer.

### **Forecasting a forward looking approach**

IIRA’s rating committee forms an opinion regarding the asset quality by anchoring its judgment on current guidelines regarding funds deployment, the concentration limits, country specific risk factors, the historical performance of the company with respect to growth in assets and the bank’s strategic plan and declared future targets.

Asset quality is also predicated in current market trends. Strong rivalry among competing banks may force the banks to increase the market share by compromising on asset quality. Risk based pricing for loan is difficult in such a situation and even the conservative banks will find it difficult to stay conservative and meet the market needs. The banks are able to price the loan with respect to the risk that they are taking only if the market allows them to do that. Recent sub-prime crisis is an example.

### **Analytical conclusions regarding economic values**

The economic value of asset or liability is the fair market value at which it can be traded in an arm’s length transaction. It can be estimated with the help of present value of the associated cash flows. It is also regarded as fair value of the asset.

The asset, liability and equity books are adjusted to reflect true economic values; the principle of conservatism is adhered to while making such adjustment. This means that if there is an unrecognized loss it will be included while the unrecognized gain will be ignored or eliminated.



While analyzing Sharia compliant instruments we give importance to the economic substance of the transaction rather than its form. Musharaka and Mudarba though are investments, but IFIs are expected to perform due diligence at par with lending activities to ensure asset quality

### **Liquidity and Fund management**

Liquidity management is the key factor that will determine the proximate ability of an institution to honor its obligations. Liquidity analysis is performed using combination of ratios and qualitative criteria; focus of the analysis is on the Structural management of balance sheet in which funding mix is analyzed. Funding mix is the resources which are either internal (i.e capital and equity) or external (deposits, commercial papers, other debt instruments or interbank lenders). The funding mix is analyzed for its diversity and for the core and non core components. The core funding constitutes the unencumbered portion of the capital and the stable portion of the customer deposits.

The liquidity situation is paramount in the stressed scenario hence the conditions under stress is also analyzed and 2-3 different scenarios are contemplated for this purpose to check the institution’s resilience.

Ability to cope with such handicaps as lack of efficient and Shari’a compliant short term instruments, lender of last resort and salability of loan portfolio in secondary market is also analyzed.



### **Capital and evaluating capital adequacy**

Growth of capital from internal sources and external capital injections is analyzed

Extent and materiality of any hidden reserves and unaccounted impairment is looked at

Regulatory requirements are looked at to ensure adequacy of capital to protect against credit, market and operational risk

In addition to meeting regulatory requirements the capital of Islamic banks should be able to cover fiduciary and displaced commercial risk

Displaced commercial risk can be accounted for with the help of profit rate risk disclosure which should bucket assets and liabilities with respect to earlier of maturity or re-pricing. In case they are not linked with periodic base rate, liabilities of IFIs should be assumed to be re-priced at maturity.

### **Earnings**

The earnings are assessed on the basis of predictability and sustainability. This will be probable if a sizable junk of the institution’s earnings emanates from the loyal retail customer base and all the non core and non recurrent items are excluded. Customer loyalty will be reliable only if the historical returns are comparable with the market returns offered. The presence of IRR and PER serves to mitigate the risk in failing to meet the market expectations.



**“Rating Methodologies for IIFS and Islamic Financial Instruments”**

*By: Jamal Abbas Zaidi*

The diversification may ensure that the seasonal downturn in one area is offset by up surge in other areas thereby not exposing the earning streams to seasonal factors. Diversification is assessed with respect to business line, industry, customers, and geography.

Adjustments in earnings and capital are made to reflect true economic value by eliminating non core income and unrealized gains

Beside these very important considerations efficiency ratios analyze the institution’s ability to effectively utilize its resources.

**Management Information Systems**

The management information system is assessed on the criteria of how it meets the customer needs, provides competitive edge to the management and information for control purposes

Additionally the IT systems are assessed for their ability to respond to the requirements of the Islamic Banks such as separation of URIA funds and current account and equity funds and ability to ascertain return attributable to current account and equity and return attributable to URIA

The allocation of financial and human resources reveals banks’ commitment for IT development

Ability of MIS to record the sequence in Murabaha which is critical to Shari'a compliance



## **Reputation & Resources**

Franchise value of the bank is assessed by degree of market penetration through branch network, brand recognition, pricing power, and loyal customer base

The level and probability of support of other groups & government in times of crisis

IIRA’s perception that selective adherence to Shari'a principles can repel or alienate the target customers with long term damaging consequences