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Credit Spotlight: Additional Considerations for Rating Islamic Finance Institutions and Sukuk

GCR's ratings on Islamic Finance institutions (IFI) and sukuk are not subject to distinct ratings criteria, despite very specific features. Our core framework and sector specific criteria, alongside the below addendum, will therefore be used to frame the ratings on IFI. However, GCR does recognise that emphasis will be placed on such factors as liquidity management, risk concentrations and collateralisation when analysing IFI.

In regards to sukuk, GCR will accord issue ratings and equity content in line with existing methodologies on an asset class basis. Typically, we expect to rate two types of sukuk. The first type of sukuk can be referred to as asset based, which, in most cases, is more akin to conventional senior unsecured bonds (and more rarely to secured bonds). Both issue credit ratings and senior unsecured (or secured) bond ratings can be accorded to such instruments. The second type of Sukuk is more akin to a conventional asset-backed securitisation.

Islamic Finance Analytical Considerations

There are a few major features within Islamic Finance that materially differentiate it from conventional banking. Whilst GCR's core analytical approaches do not change, we can place different emphasis upon existing rating framework or criteria factors.

One of the key concepts is 'riba' or the strict prohibition against collection of interest. This concept is linked to Islamic finance not recognising the 'time value of money', which underpins a lot of conventional finance. However, it goes further as riba is sometimes translated as 'usury' and therefore the charging of interest can be considered to be an unlawful gain, as the lender is not (in the eyes of Shariah law) really proving a service to the borrower.

Another key concept is the ban on 'gharar' or undue risk taking/speculation. We also believe this materialises in Islamic finance's typical requirement that any obligation or financial transaction be backed with physical assets, however it also typically means that derivative transactions, such as forwards, futures and options are rarely used in Islamic finance. The loan book (or equity investments) for Islamic finance also enforces a ban on 'haram' or investment in unlawful assets. This will typically imply that financial institutions do not lend into asset classes considered to be forbidden. For example, industries associated to alcohol, smoking and gambling.

From a credit perspective of the loan book, GCR nonetheless believes Islamic banks do not materially differ from conventional bank. In regards to the mechanics of lending, Islamic finance closely matches conventional instalment finance or financial leasing.

In order to remain shariah compliant, Islamic loan products require that the borrowers pay back the value of a physical asset purchased plus a pre-defined but periodically re-priced (typically quarterly) profit margin. The Islamic loan is concurrently pledged with a white good, vehicle or home. Short-term loans for household consumption are called 'murabaha' and longer-term loans, typically used of vehicle finance or home loans, are called 'ijara'.

Non-payment of the principal or profit margin is considered to be a default and will be treated like a non-performing loan under the GCR criteria. In the most general terms, the loan book of Islamic institutions is often relatively better collateralised (as loans are all asset backed), favour real estate back lending and lack diversification versus conventional market peers.

Another key feature of Islamic contracts is that they may also require the sharing of risks and rewards from the investment amongst all parties. On the asset side of the balance sheet, this feature can be seen most commonly through 'mudharaba' or 'musharaka' portfolios, which are akin to (and will be treated like) equity participations in unlisted companies under the GCR criteria. However, more commonly, this feature can also interact with the liability side of the balance sheet through profit-sharing investment accounts (PSIAs) and equity-like Sukuk instruments (discussed below).

PSIAs are typically short-term, untradable, and potentially loss-bearing mudharaba-based instruments. In effect, they are most like short-term deposits with variable (including potentially negative) returns that depend on the entity's profitability. In GCR's opinion a negative return on the PSIAs doesn't necessarily amount to a default and the value of the PSIAs are typically managed by contra-liabilities in the form of profit equalisation reserves. Nonetheless, failure to pay PSIAs on time and in full could be viewed very negatively under our methodology, akin to the 'cc' or 'c' definitions (see GCR Ratings Criteria, Scales, Symbols & Definitions) under our criteria (although GCR do not rate PSIAs). As a result, because of the threat that an earnings shock could trigger a liquidity event GCR consider PSIAs as non-core deposits. Furthermore, if earnings are weak and the profit equalisation reserves are low we could lower the liquidity assessment.

Other liabilities include 'qardh hasan' or 'wadia', which are non-remunerated current accounts, that are guaranteed by the institutions and usually payable upon demand but can be behaviourally sticky. GCR would typically see such deposits as core deposits. This is because stronger customer loyalty is a key trait of Islamic finance, which could be a benefit to the competitive position and funding costs/stability.

Islamic banks also borrow/lend from/to the Islamic interbank market, again called 'murabaha' (or 'tawarruq', as such murabaha transactions are usually commodity-based) or 'wakala'. These tend to be short-term commodity-backed placements that can roll into behaviourally longer-term funding. Typically, GCR will include such funds as non-core deposits and relative liquid assets, thereby extract them from stable funding ratios but including them in liquidity calculations. However, this may change on a case-by-case basis.

Due to the above, it is GCR's opinion that the liability structure of Islamic financial institutions can defer meaningfully from conventional banks, which can have a knock-on effect of funding stability and liquidity management of Islamic institutions. The latter is especially true when you consider that due to the relatively stricter standards of Islamic banking, there tends to be less liquid assets and more intrinsic links between liquidity and solvency risk. As a result, additional emphasis on the management of liquidity is placed on the analysis on Islamic financial institutions.

Sukuk Bond Ratings & Determining Equity Content

Due to the fact that sukuk notes are bond-like investments, the GCR ratings accorded to Sukuk are broadly in line with GCR issue rating criteria (see appendix in the relevant criteria pieces, for example page 22 in the GCR Ratings Criteria for Financial Institutions).

When considering the similarities between sukuk and conventional bonds, the same principles described above can broadly be applied. For example, sukuk bonds are backed by physical assets which generate cash flows from rental or profit margins. These cash flows are sometimes shared (in terms of income/loss sharing described above) with the originator and in the form of coupons to the sukuk investors. The repayment of the principal is afforded by the sale of the underlying assets at maturity of the sukuk or sometimes completely by cash flow from the underlying assets.

Typically, GCR will rate two types of sukuk. The first type can be referred to as asset-based, which is more akin to conventional senior unsecured bonds or (more rarely) to secured bonds. The second is more akin to a conventional asset-backed securitisation.

Asset-based sukuk's transfer assets in form rather than substance, i.e., contractually the assets belong to the note holders but they have not been transferred to a special purpose vehicle (SPV). Then upon maturity, the physical assets are transferred or sold at a pre-defined price (often back to the originator) and the proceeds (theoretically or physically) are used to settle principal. During the term of the sukuk, the cash flows from the assets are utilised to pay coupon. For this type of sukuk, GCR will require a guarantee from the originator (or another 3rd party) in order to cover for any gap or mismatch in between the expected coupons and the underlying returns from the assets.

Typically, the issue rating on the sukuk would be equalised with the guarantor of the notes. If the guarantor of coupon differs from the party that will ultimately repay principal, the lower issuer credit rating will apply. Furthermore, like conventional bonds, the sukuk could also be subject to the credit hierarchy and may rank to senior or subordinated obligations of the issuer.

Should a Secured Bond rating be accorded, an $_{(EL)}$ suffix will be added and the criteria applied will be the Criteria for Rating Secured Bonds. Secured bond ratings take into account the fundamentals of the issuer and provide notching up for potential recoveries, upon a default. Secured bond ratings can therefore not be fully compared with a traditional issue credit rating (the latter, which is also an expression of expected loss, but refers to probability of default and an average historical loss given default (LGD) for generalised senior unsecured debt).

Asset-backed sukuk, like conventional securitisation, take shariah-compliant assets on the issuer's balance sheet and sell the ownership rights (on a true-sale basis) to a special purpose vehicle at the cost of the issuance value. Consequently, all cash flows generated from the pool of assets service the coupons. Like any conventional securitisation transaction sukuk can be subject to 'tranching'. The issue ratings on asset-backed sukuk would therefore be accorded with a $_{(SF)}$ suffix and in line with the GCR securitisation criteria. As such the issue rating would reflect the credit strengths afforded by the cash flows from the underlying assets alongside consideration of the structure, legal risk and servicer risks. For more information, please see the Criteria for Rating Structured Finance Transactions.

Similar to conventional bonds (albeit for different reasons), sukuk instruments can differ significantly regarding the equity and debt like content within contract. When according equity content to the sukuk, GCR will use the same principles as in the GCR Rating Criteria (dependent on the asset class). In this regard, sukuk may count as a capital instrument as long as the instrument has the ability to delay coupon and convert or write down principal to support capitalisation on a 'going-concern' basis. For this reason, whilst GCR believe that any instrument aligned with 'musharaka' principles are typically not rateable, they are more likely to provide equity uplift because they are more equity than debt like in their construct.

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Structured Finance Transactions, September 2018
Criteria for Financial Institutions Ratings, May 2019