

Using Fund Ratings As A Tool To Assess Credit and Market Risks In Sharia Funds

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Using Fund Ratings As A Tool To Assess Credit and Market Risks In Sharia Funds

The economic boom in the Gulf Cooperation Council (GCC) region has fueled the emergence of Islamic finance in the international market in the past decade. Revenue growth in this region has particularly benefited the asset-management sector. The Middle East is by far the largest market for Sharia-compliant funds, but conventional players in Europe, South Africa, and the U.S. have also launched a number of funds that comply with Sharia law during past years, enhancing their product range to meet the specific requirements of Islamic investors seeking to invest in this asset class.

In 2008, Ernst & Young estimated that there were 500 Sharia funds, although the number is constantly growing. The number of product types remains limited, which Standard & Poor's Ratings Services believes is largely due to the nascent nature of Sharia funds. Funds also have to be invested in ways that are permitted under Islamic law. Sharia funds, unlike traditional bond funds, do not invest in conventional rated fixed-income securities because these are, by definition, financial instruments that accumulate interest and are therefore not considered Sharia-compliant.

In May 2010, we assigned our first 'AAf/S1+' fund credit quality and volatility ratings to a newly established Sharia fund--EFH Funds SCA SICAV-SIF-Liquidity Subfund, domiciled in Luxembourg and managed by European Finance House, the European financial arm of Qatar Islamic Bank. Islamic finance investors have shown an increasing interest in diversifying their investments from traditional Sharia-compliant financial instruments. They are starting to invest in Sharia-compliant mutual funds like the EFH Funds SCA SICAV-SIF-Liquidity Subfund and may look at Sharia fund ratings as a way to help them assess their credit- and market-risk exposure.

We see rating Sharia funds as a way to enhance credit-risk awareness in this asset class. Most Sharia funds are equity-, commodity-, or lease finance-based funds, but some of them, despite being invested in Islamic financial instruments, are similar to fixed-income funds.

Islamic Law Requires Sharia Funds To Invest In Sharia-Compliant Investments

The fundamental principle of Islamic finance is that it prohibits interest-bearing investments, also called "riba." Sharia boards or other governance structures decide whether a transaction, instrument, or institution is compliant with Islamic law. Conventional fixed-income securities are, by definition, financial instruments that provide a steady return based on an interest rate, and would typically not be considered Sharia-compliant. Islamic financial instruments, by contrast, are structured to produce a profit instead of a fixed return tied to their face value. To comply with Sharia law, funds may only invest in Sharia-compliant assets.

It is generally understood in Islamic finance that, in theory, neither the principal nor the rate of profit can be guaranteed except for specific cases such as the unremunerated current accounts with financial institutions. The shareholder of a Sharia fund typically shares the risks and rewards of the investment. We understand that the funds are typically designed so that shareholders will see the value of their investment increase in proportion to the profit the fund produces. If the fund produces a loss, shareholders will usually have to bear the loss on a pro rata basis, unless it is due to management negligence or misconduct.

Appropriate investments for Sharia funds

Although we do not consider Sharia funds to be typical money-market funds, some of them can provide liquidity by investing in financial instruments or transactions that are similar in many ways to conventional money-market or fixed-income instruments.

Wakala. Some Sharia funds invest in wakala, which is an agency contract that includes in its terms a fee for the expertise of the agent. We view wakala agreements as management mandates where the fund manager ("muwakkil") appoints a financial institution ("wakil") to invest a certain amount for a fixed period on its behalf. The muwakkil then receives a profit paid on a fixed schedule. Wakala may incorporate a liquidity feature to enable the fund manager to meet investors' redemptions. Wakala is one of the two main types of Islamic contracts widely used between financial institutions and their clients, particularly in brokerage services, Islamic insurance ("takaful"), and fund management.

Sukuk and ijara. One of the most popular Sharia-compliant financial instruments is the sukuk, which is typically defined as a Sharia-compliant financial certificate tradable on the secondary market. Sukuks may be compared to bonds in many ways except that they do not bear interest. One of the most common structures for sukuk issuance is ijara, whereby the sukuk is structured around a pool of ijara transactions or a tangible asset being leased.

Types of Sharia funds

Given the restrictive rules by which Sharia funds must abide, many of them are invested in equity, ijara, commodity, murabaha, or a combination of these types of assets.

In our view, equity funds are by far the leading asset class in Islamic funds. They are permitted to invest only in businesses that are deemed acceptable by Sharia boards. Although some of them may use a capital-protected strategy, equity funds are not eligible for a fund credit rating.

Ijara funds aim to lease out assets they purchase, such as real estate or equipment, to their end users. Ijara contracts are one of the few Islamic contracts that incorporate a fixed-income stream derived from the use of the underlying leased asset.

Another type of Sharia fund typically invests in commodities. Commodity murabaha funds are closed-end funds specifically set up to purchase commodities on behalf of clients and sell them back to these clients at an agreed margin of profit. This type of transaction can be compared to a fixed-rate loan, as the fund will typically pay to purchase the commodities, and therefore lend money to the shareholder at an agreed rate of profit. Murabaha transactions typically provide a fixed income stream to Islamic banks seeking a risk/return profile similar to interbank deposits. Their profit is often determined using an interest benchmark such as LIBOR.

Other Sharia funds are mixed investment funds investing in a combination of equity, commodities, and leased underlying investments.

Examining Sharia Funds More Closely Using Our Funds Criteria

We offer three types of ratings for funds: fund credit quality ratings, fund volatility ratings, and principal stability fund ratings (PSFRs; also known as money-market fund ratings). When rating Sharia funds, we first consider what type of rating to assign. So far, Sharia funds have proved eligible for the first two types of ratings.

Our PSFR criteria effectively exclude Sharia funds

PSFRs reflect our opinion of a fund's capacity to maintain a stable net asset value (NAV) and to limit exposure to principal losses due to credit risk. However, most Sharia funds we have seen to date are unlikely to meet our criteria for a PSFR regarding issuer credit quality, issuer diversification, and individual/portfolio maturity.

For example, money market funds that we currently rate 'AAAm' are invested in what we consider to be diversified portfolios, comprising high-credit-quality short-term money market instruments rated at least 'A-1', with a maximum weighted average portfolio maturity of 60 days. We assign PSFRs to stable NAV funds and accumulating NAV money-market funds. These ratings reflect our view of a fund's capacity to maintain principal stability and to limit exposure to principal losses due to credit risk. We expect that due to the current lack of eligible investments for Sharia funds, it would be difficult for most of these funds to meet our PSFR criteria. (For more information see "Principal Stability Fund Ratings Criteria Updated," published March 10, 2009, on RatingsDirect.)

Fund credit quality and fund volatility ratings are more likely to be assigned to certain types of Sharia funds

Our fund credit quality and fund volatility ratings are not based on any explicit diversification criteria.

Our fund credit quality ratings reflect our evaluation of a fund's protection against losses from credit defaults (see "Fund Credit Quality Rating Criteria," published Feb. 2, 2007, on RatingsDirect). For a Sharia fund to be eligible for a fund credit quality rating, we look to see whether the Sharia fund has invested in rated Islamic financial instruments that share characteristics with fixed-income securities.

In addition to our fund credit quality ratings, we also assign fund volatility ratings to Sharia funds, which reflect our opinion of the fund's sensitivity to interest rate movements, credit risk, investment diversification or concentration, liquidity, leverage, and other factors. In our analysis, we assess the volatility of funds' monthly returns against government indices with different maturity bands. We believe that volatility ratings provide investors with a benchmark for risk and return comparisons. Our evaluation includes portfolio risk analysis, historical return analysis, and management assessment (see "Fund Volatility Rating Criteria," published Feb. 2, 2007, on RatingsDirect).

Assessing Counterparty And Investment Risk

One of the key factors in assigning a fund credit quality rating to Sharia funds as fixed-income funds is our assessment of the creditworthiness of counterparties and investments.

Evaluating a fund's portfolio when assigning fund credit quality ratings

We have assigned our fund credit ratings to various types of fixed-income funds or portfolios, including bond funds, local investment pools, and cash-enhanced funds. Under our rating criteria, sukuk funds will typically be eligible for a rating as long as we rate all the underlying instruments of the fund's portfolio. A maximum of 25% of the underlying assets may be rated by other rating agencies.

When assigning a fund credit quality rating, we evaluate the fund's portfolio credit risk and conduct a qualitative assessment of the fund management's experience, credit, and investment policies. Fund credit ratings reflect our view of a fund's overall credit quality and its exposure to credit risk. Likewise, our assessment of a Sharia fund reflects our view of the quality of management, the fund's investment strategy, and the creditworthiness of the investments held in its portfolio, such as sukuks. We also typically consider the counterparties with which the fund engages in

market transactions--for example, wakala agreements. In addition, when assessing specific contracts such as wakala agreements, we consider whether the fund would bear any additional cost if the contract terminated early.

Applying our existing funds criteria

To evaluate a fund's credit risk using our existing criteria, we apply credit risk factors associated with each credit rating category and maturity bucket to the fund's percentage holdings. The credit risk factors are derived from our historical rating default and transition studies. The credit score obtained by the fund corresponds to a specific rating category. The final credit rating assigned to a fund takes into account our qualitative assessment of the fund management. Our ratings do not reflect our opinion on the fund's compliance with Islamic law.

Consequently, the ratings we would assign to Sharia funds would be based primarily on our view of the creditworthiness of Islamic counterparties and the ratings assigned to financial instruments in which they invest. We believe that credit risk associated with Islamic financial institutions bears unique features compared to conventional financial institutions. We have therefore developed a specific set of criteria to better reflect what we see as the various risks of operating within the principles of Islamic law.

Ratings On Islamic Financial Institutions Play A Role In Rating Sharia Funds

Our fund credit quality ratings reflect our opinion on the level of protection a fund provides against losses due to credit defaults on the assets the fund holds. The creditworthiness of Islamic financial institutions to which a fund is exposed and ratings on Islamic instruments such as sukuk held by the fund play an important role in our assessment of the fund's overall credit quality.

Rating Islamic banks and Islamic instruments

Broadly speaking, we apply the same methodology used to rate conventional banks to rate Islamic banks. However, we do take into account the specific features that may arise from operating in compliance with Sharia. Typically, for a financial institution, compliance with Sharia principles may, in our opinion, give rise to some specific risks.

Credit risk

One of the principles of Islamic finance is that all the transactions have to be backed by a tangible asset, which means that Islamic banks tend to have more collateral than do their conventional counterparts. However, we understand that in some cases collateral foreclosure under a default scenario may be difficult or impossible. Indeed, for mortgage lending, although an Islamic bank is theoretically in a position to evict a customer from a property and resell it in the case of a default on the loan backed by the property, we understand this would generally be unlikely to happen owing to its "social responsibility." There are, however, instances when such a decision may be made by a bank and authorized by its Sharia board--notably when specific conditions were set out and agreed on before the conclusion of the transaction. In such cases, foreclosure may be easier than for conventional banks, as the property belongs to the Islamic bank under some Sharia-compliant structures.

In our view, a bank's credit risk can also be influenced by how its operations are funded. Under the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) reporting standards, there is a separation between assets financed through equity and assets financed through profit-sharing investment accounts (PSIA). In the case of a default on some assets financed through PSIA, the holders are supposed to share the losses.

Thus, we understand that funding a loan portfolio through PSIA could be viewed as a partial transfer of credit risk to PSIA holders under the AAOIFI's reporting standards. We believe that a loss could trigger some PSIA holders to

withdraw their funds, which could translate into liquidity issues. We assume that Islamic banks would usually be inclined to support PSIA holders in the case of issues related to the credit quality of the underlying assets.

Market risk

We have observed that Islamic banks largely escaped the first wave of the current financial crisis. We understand that this is partly because they did not invest in structured investment products; the majority of these are based on interest, which is forbidden in Sharia law. However, we do not think this means that they are not exposed to market risk. Indeed, we observe that their investment portfolios are generally composed of equities, sukuk, and real estate, which can be sources of market risk. We also see that many Islamic banks are exposed to margin risk that arises from their intermediation activity and the fact that some of their exposures, such as murabaha contracts, may be at fixed margins.

Funding and liquidity risk

Some Islamic banks rely to a certain extent on PSIA's for funding. We understand the terms and conditions of PSIA's typically provide for depositors to be entitled to receive a share of the bank's profits, but also oblige them to bear potential losses pertaining to their investment in the bank. This profit-sharing principle--according to which investors and entrepreneurs must share the risks and rewards of a given venture--is core to Islamic finance. We believe that it may translate into a displaced commercial risk, however, and could result in a liquidity stress if PSIA holders decide to withdraw their deposits at maturity if the remuneration served by the bank is not in line with their expectations. We understand that Islamic banks have developed several layers of defense to manage this risk.

We have developed specific methodologies to rate Sharia-compliant instruments, given their nature. These apply mainly to sukuk and PSIA's. In our sukuk rating methodology, we distinguish among three types of sukuk from a credit rating perspective. These are:

- Sukuk with full credit enhancement mechanisms. The ratings are based on the rating on the entity providing these mechanisms;
- Sukuk with no credit enhancement mechanisms. We base our ratings on our assessment of the value and the performance of the underlying assets to the transaction under different stress scenarios; and
- Sukuk with partial credit enhancement mechanisms. The ratings are based on a combination of the two previous methodologies.

As far as PSIA's are concerned, due to their loss-absorbing nature, we do not generally rate them under our classic rating methodology as we see that a negative return is deemed as a default in the conventional world, but is permissible under the PSIA's' terms and conditions. Therefore, we have developed a specific methodology to address this unique characteristic; stability ratings. These ratings reflect our opinion about the expected stability, defined as sustainability and variability, of cash flows distributable to the PSIA holders of an Islamic bank.

The impact of the global financial crisis on Islamic banks has been varied

We believe that most Islamic banks have, in general, been more resilient to the financial crisis than their conventional counterparts. However, some of them were particularly affected by the downturn in the housing and equity markets. Credit ratings on Islamic financial institutions provide our assessment of the relative creditworthiness of these institutions.

Our ratings on Islamic financial institutions in the GCC region range from 'CCC-/Negative/C' for Bahrain-based Gulf Finance House to 'A/Stable/A-1' for Saudi-based Al Rajhi Bank. The outlooks for rated Islamic financial

institutions in the region range from negative to stable, depending on their country of location.

Ratings On Islamic Financial Institutions In The Gulf Cooperation Council

	Country	Ratings
Albaraka Banking Group (B.S.C.)	Bahrain	BBB-/Stable/A-3
Al Rajhi Bank	Saudi Arabia	A/Stable/A-1
BEST RE	Tunisia	BBB+/Stable/--
Dubai Islamic Bank	United Arab Emirates	BBB-/Watch Neg/A-3
Dubai Islamic Insurance & Reinsurance Co. (Aman)	United Arab Emirates	BBB/Negative/--
Gulf Finance House	Bahrain	CCC-/Negative/C
Hannover ReTakaful B.S.C.	Bahrain	A/Stable/--
First Takaful Insurance Co.	Kuwait	BBB-/Stable/--
Islamic Development Bank	Saudi Arabia	AAA/Stable/A-1+
Kuwait Finance House	Kuwait	A-/Negative/A-2
Salama/Islamic Arab Insurance Co. (P.S.C.)	United Arab Emirates	BBB+/Stable/--
Sharjah Islamic Bank	United Arab Emirates	BBB/Stable/A-2
Takaful International Co. BSC	Bahrain	BBB/Stable/--
Takaful Re Ltd.	United Arab Emirates	BBB/Stable/--
Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	BB/Negative/--

Ratings are Standard & Poor's at April 30, 2010.

Demand For Ratings On Sharia Funds Depends On The Expansion Of Islamic Finance

In our opinion, the growth in the number of credit and volatility ratings we assign to Sharia funds will depend on the levels of credit ratings assigned to Islamic financial institutions. We expect it will also be conditioned by further innovations from the Islamic finance sector, allowing it to offer a broader and more-liquid universe of rated investments to Sharia funds that are seeking to diversify their counterparty exposures and investments. Furthermore, we believe Islamic investors' risk tolerance and appetite for funds that combine Sharia-compliant investments with credit and market risk management may influence the demand for Sharia fund credit and volatility ratings.

Related Criteria And Research

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- The Sukuk Market Is Likely To Show Steady Growth In 2010, Jan. 27, 2010
- Principal Stability Fund Ratings Criteria Updated, March 10, 2009
- Risk Management For Islamic Financial Institutions: A Rating Perspective, Jan. 15, 2008
- S&P Launches Stability Ratings For Islamic Banks Offering Profit-Sharing Investment Accounts, Sept. 21, 2007
- Standard & Poor's Approach To Rating Sukuk, Sept. 17, 2007
- Fund Credit Quality Rating Criteria, Feb. 2, 2007
- Fund Volatility Rating Criteria, Feb. 2, 2007

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