

Rating Shari'ah-Compliant Financial Institutions and Sukuk

Presented by:

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**Milan
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Moody's Investors Service

Introduction

Moody's Acknowledges the Importance of the Islamic Financial Industry

Moody's Investors Service:

- **Understands** Shari'ah-compliant banking and finance, as well as its specificities;
- **Is committed** to its Islamic constituency;
- **Provides ratings services** to Shari'ah-compliant issuers, including banks, and to a wide range of Sukuk; and
- **Allocates analytical and development resources** fully dedicated to Islamic issuers and investors.

Agenda

- 1. Overview of Moody's involvement in the Islamic financial industry**
- 2. Moody's approach to rating Islamic financial institutions (IFIs)**
- 3. Islamic banking in the Middle East: key trends and analytical findings**
- 4. Ratings Sukuk: the dual approach**



1. Overview of Moody's involvement in the Islamic financial industry



Moody's Investors Service

Overview

Moody's is familiar with Sharia-compliant finance: rating Islamic banks

- More than 10 years in rating Islamic banks.
- Today Moody's provides ratings to 10 recognized IFIs managing total assets in excess of \$150 billion.

| IFI Name | Country | Bank Financial Strength Rating | Baseline Credit Assessment | Local Currency Ratings | Foreign Currency Ratings | Rating Type | Outlook |
|---------------------------|--------------|--------------------------------|----------------------------|------------------------|--------------------------|-----------------|---------|
| Abu Dhabi Islamic Bank | UAE | D | Ba2 | A2/P-1 | A2/P-1 | Issuer Ratings | Stable |
| Al Rajhi Bank | Saudi Arabia | C | A3 | A1/P-1 | A1/P-1 | Deposit Ratings | Stable |
| Asya Katilim Bankasi A.S. | Turkey | D | Ba2 | Ba1/NP | B1/NP | Deposit Ratings | Stable |
| Bank Al-Jazira | Saudi Arabia | D+ | Baa3 | A3/P-2 | A3/P-2 | Deposit Ratings | Stable |
| Boubyan Bank | Kuwait | D | Ba2 | Baa2/P-2 | Baa2/P-2 | Deposit Ratings | Stable |
| Dubai Bank | UAE | D | Ba2 | A3/P-2 | A3/P-2 | Issuer Ratings | Stable |
| Dubai Islamic Bank | UAE | D+ | Baa3 | A1/P-1 | A1/P-1 | Issuer Ratings | Stable |
| Kuwait Finance House | Kuwait | C- | Baa1 | Aa3/P-1 | Aa3/P-1 | Deposit Ratings | Stable |
| Tamweel PJSC | UAE | D | Ba2 | A3/P-2 | A3/P-2 | Issuer Ratings | RUR |
| Bahrain Islamic Bank | Bahrain | D+ | Ba1 | Baa1/P-2 | Baa1/P-2 | Issuer Ratings | Stable |

Overview

Moody's is familiar with Sharia-compliant finance: rating Sukuk

- More than 7 years in rating Sukuk.
- So far, Moody's has assigned ratings to 16 global Sukuk for a total amount of \$21 billion to date.

| Issuer | Issuance Amount (Mil. US\$) | Moody's Rating |
|---|--------------------------------|----------------|
| ADIB Sukuk Co. Ltd. | 5 000 | A2 |
| DIB Sukuk Co. Ltd. | 750 | A1 |
| DP World Sukuk Ltd. (Obligor: DP World) | 1 500 | A1 |
| Dubai Sukuk Center Ltd. (Obligor: DIFC Investments LLC) | 1 250 | A1 |
| EIB Sukuk Co. Ltd. Programme | 1 000 | A1 |
| Golden Belt 1 B.S.C. (Obligor: Saad Trading Cont. & Fin. Serv. Co.) | 650 | Baa1 |
| JAFZ Sukuk Ltd. (Obligor: Jebel Ali Free Zone FZE) | 2 043 | A1 |
| Malaysia Global Sukuk Inc. | 600 | A3 |
| MBB Sukuk Inc. (Subordinated) | 300 | A3 |
| NIG Sukuk Ltd. (Obligor: National Industries Group) | 475 | Baa2 |
| Qatar Alaqaria Sukuk Co. (Obligor: Qatar Real Estate Inv. Co.) | 300 | A2 |
| Sarawak Corporate Sukuk Inc. | 350 | Baa1 |
| Sun Finance Ltd. | 1 368 | various |
| DB Sukuk Ltd | 5 000 | A3 |
| Tamweel Sukuk Ltd | 272 | A3 |
| Tamweel Residential ABS CI (1) Ltd., of which: | 210 | various |
| Total amount of Sukuk issuances rated by Moody's: | 21 068 | |

Overview

Moody's is familiar with Shari'ah-compliant finance: analytical production

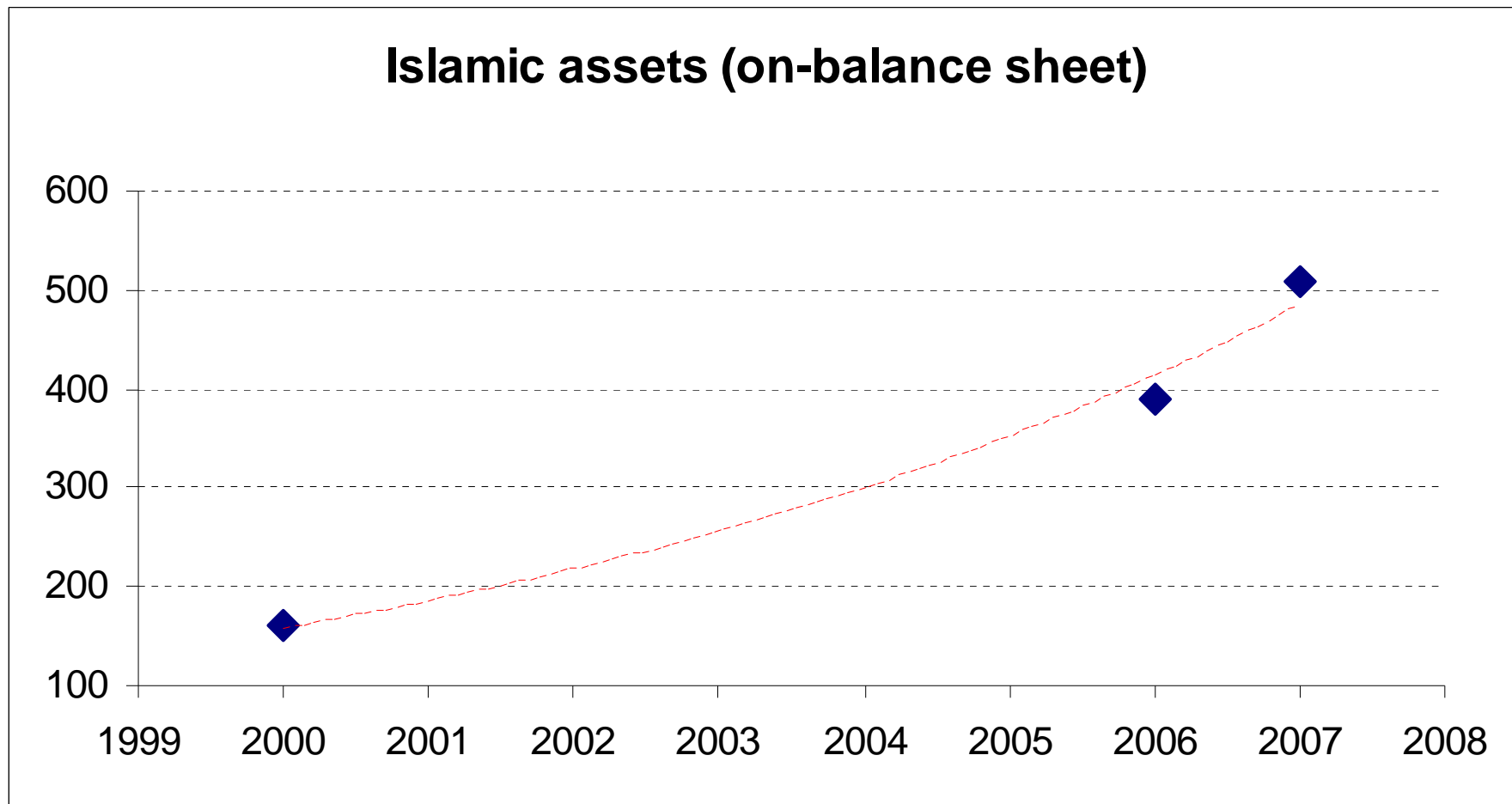
Special Comments

- Risk Issues at Islamic Financial Institutions, *January 2008*
- Understanding Moody's Approach to Unsecured Corporate Sukuk, *August 2007 (103919)*
- Asian Sukuk Poised for Fast Growth: Market Review and Introduction to Moody's Rating Approach, *August 2007 (104446)*
- Shari'ah and Sukuk: A Moody's Primer, *May 2006 (103338)*
- A Guide to Rating Islamic Financial Institutions, *April 2006 (97226)*
- Moody's Involvement in Rating Islamic Financial Institutions, *April 2006 (97113)*
- Regulation and Supervision: Challenges for Islamic Finance in a Riba-Based Global System, *January 2004 (81128)*
- Culture or Accounting: What Are The Real Constraints for Islamic Finance in a Riba-Based Global Economy?, *January 2001 (63369)*

Selected Sukuk Rating Actions

- Moody's rates Abu Dhabi Islamic Bank's Trust Certificate Issuance Programme, *November 2006*
- Moody's assigns (P)A1 ratings to DP World's proposed EMTN Programme and Sukuk, *June 2007*
- Moody's affirms Dubai Islamic Bank's A1 Sukuk Trust Certificates rating, *March 2007*
- Moody's rates Saad's Sukuk Issuance (P)Baa1, *April 2007*
- Moody's rates Maybank's Subordinated Sukuk Certificates ("Certificates") Baa1, *April 2007*
- Moody's rates DIFC Investments' Sukuk Issuance (P) A1, *May 2007*
- Moody's assigns A1 rating to Emirates Islamic Bank's Sukuk Trust Certificates, *May 2007*
- Moody's assigns (P)A1 ratings to Jebel Ali's proposed GMTN Programme and Sukuk, *November 2007*
- Moody's assigns (P)Baa2 rating to NIG's proposed Sukuk, *July 2007*
- Moody's assigns (P)A2 rating to Qatar Real Estate's proposed Sukuk, *July 2007*
- Moody's affirms Baa1 ratings for Sarawak Corporate Sukuk Inc certificates, *September 2006*
- Moody's upgrades Malaysia Global Sukuk Inc.'s Trust Certificates to A3 from Baa1, *December 2004*

Global Islamic banking assets

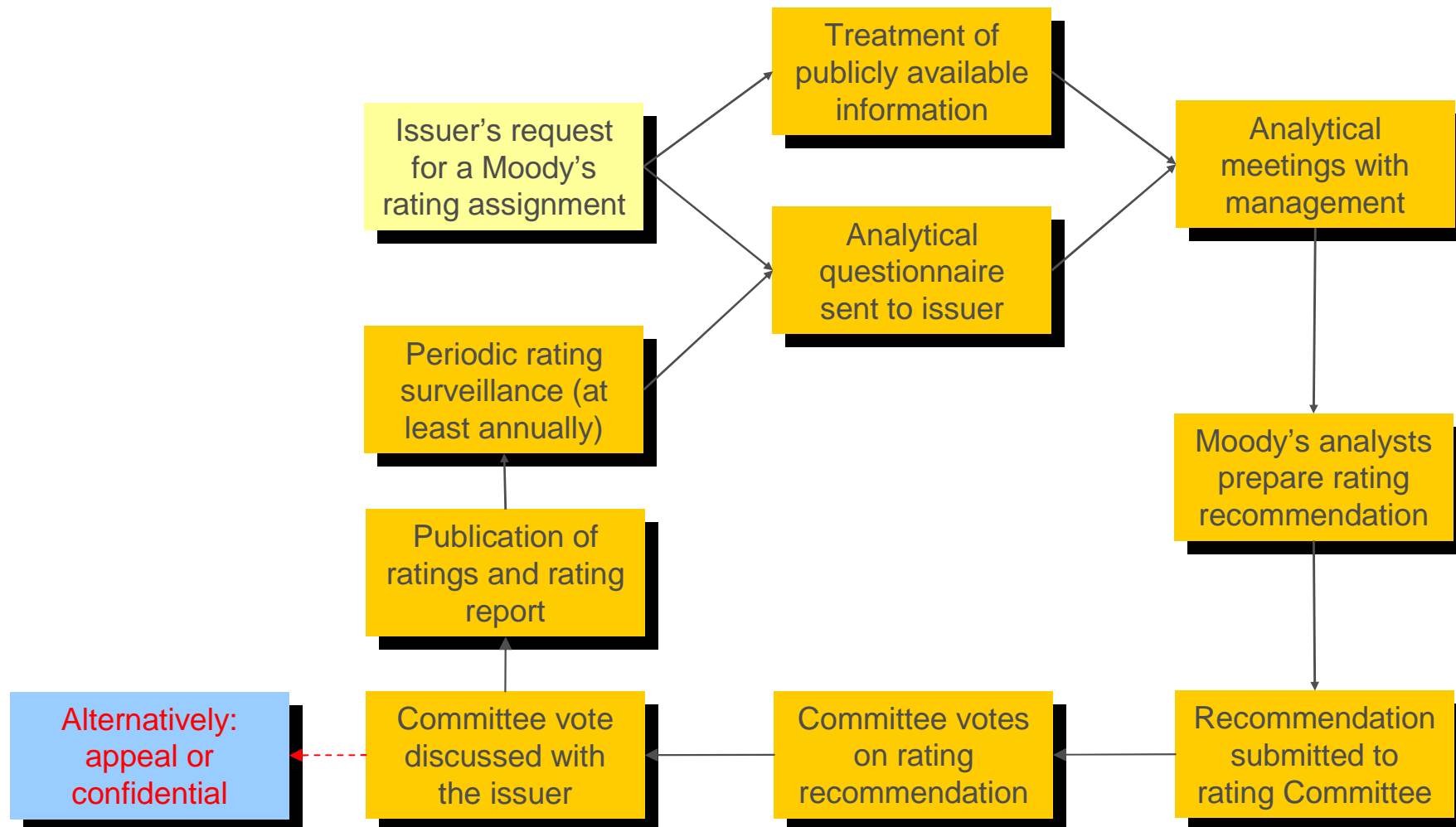




2. Moody's approach to rating IFIs



Robust and consistent rating process



Benefits of ratings for IFIs

- **Credibility, reputation, governance, and discipline**
- **Enhanced transparency, liquidity and comparability**
- **Access to more diversified funding sources**
- **Basel II and the IFSB's standard for regulatory capital at IFIs provide a vital importance to credit ratings**

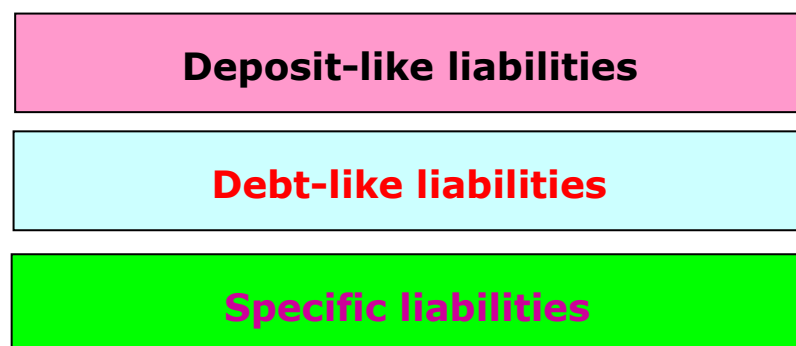
| The issuer's perspective | The investor's perspective |
|--|--|
| <ul style="list-style-type: none">• Transparency• Discipline• Benchmark• Communication• Pricing• Funding diversification• Signal | <ul style="list-style-type: none">• Comparability• Liquidity• Reliability= objectivity + independence• Pricing• Outsourcing surveillance• Upside of rating migrations |

Meaning of ratings for IFIs and their classes of liabilities: summary

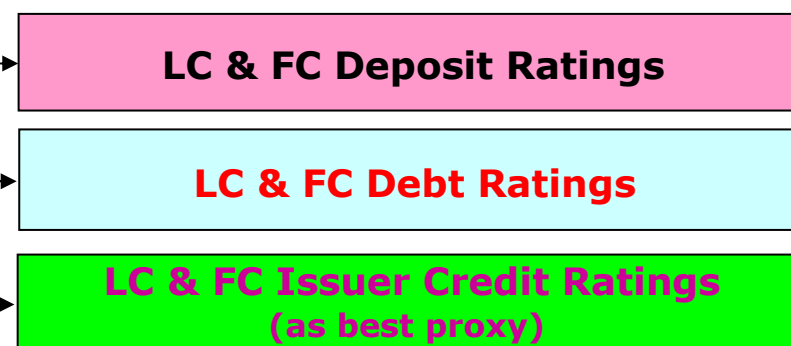
Simplified balance sheet of an IFI

| ASSETS | LIABILITIES |
|----------------------------------|---|
| Cash & quasi-cash | Nonremunerated current accounts (qardh hasan) |
| ST interbank murabaha placements | ST interbank/customer murabaha deposits |
| Investment Sukuk | LT murabaha borrowings |
| Other investments | Issued Sukuk (senior/subordinated) |
| Credit portfolio | Profit-Sharing Investment Accounts (PSIAs) |
| Participations (musharaka) | Profit Equalization Reserves |
| Fixed and other assets | Equity |

IFIs' liability categories



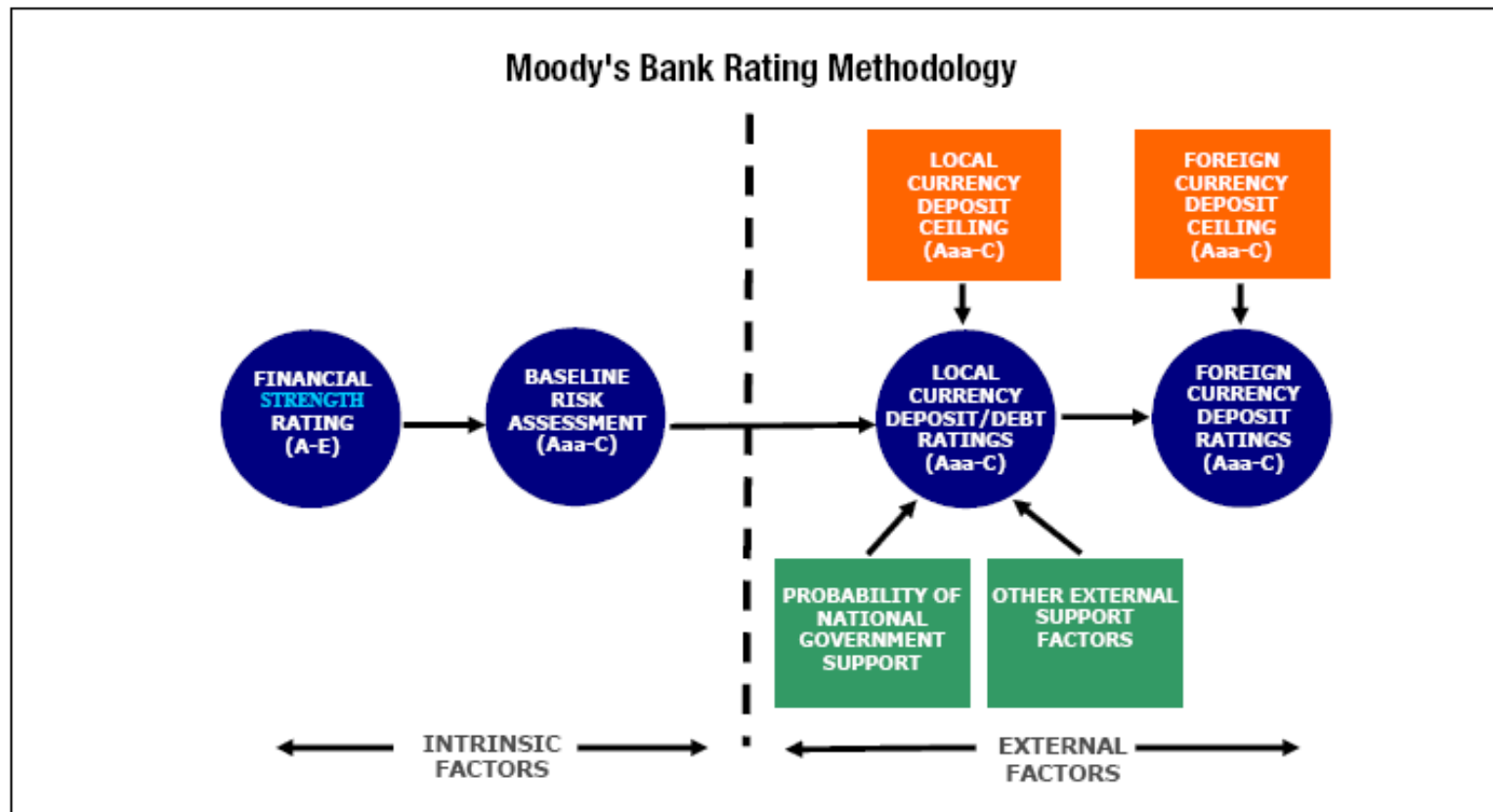
Moody's rating treatment



Reference: "The Benefits of Ratings for Islamic Financial Institutions and What they Address"
Moody's, Feb. 2008.

Meaning of ratings for IFIs and their classes of liabilities: deposit, issuer, and debt ratings

Moody's approach to bank ratings under Joint-Default Analysis (JDA) is applicable to IFIs



This methodology is applied by Moody's analysts to determine a bank's **LC & FC, LT & ST Deposit Ratings, Issuer Credit Ratings, and Debt Ratings.**

Meaning of ratings for IFIs and their classes of liabilities: treatment of PSIAs

For conventional banks, Moody's rates long- and short-term deposits of both foreign and domestic currency with the emphasis being on wholesale deposits. These ratings act as good proxies for issuer, or overall ratings, of the bank. We are rating relative creditworthiness as captured by an assessment of expected losses to depositors and other creditors. In addition, we rate the financial strength of the institution on a stand-alone basis, excluding both support and sovereign ceiling considerations. For Islamic banks, we will generally use issuer ratings and financial strength ratings to describe the overall creditworthiness of the bank and focus on the expected loss that might be incurred by a fund provider. In some circumstances, where the funding of the Islamic bank is similar – in all but name – to that of a conventional bank in its own market, we will issue deposit ratings to allow easy comparison of creditworthiness among peers. It is our intention that any credit ratings assigned to Islamic financial institutions be comparable – in the dimension of expected loss – to ratings assigned to conventional banks.

Source: "A Guide to Rating Islamic Financial Institutions", Moody's, April 2006

- **We have adopted so far the perspective of “*hard default*” on PSIAs, i.e. breach of any contractual obligation.**
- **“*Soft default*” is out of the scope of the rating definitions applicable to IFIs. Therefore, a negative return on PSIAs, absent negligence or misconduct, would not be deemed a default as per our methodology and criteria.**
- **Consequently, PSIA-holders should refer to the IFIs’ Issuer Credit Ratings (ICR) as the best proxy for Moody’s opinion as to the IFI’s overall creditworthiness.**
- **Fund providers other than PSIA-holders could refer to the ICR and to Deposit Ratings as well as Debt Ratings when these have been assigned.**

Quality of governance is a key rating factor

- **Corporate Governance (CG) is an important aspect of our Bank Financial Strength Rating (BFSR) methodology.**

1. Franchise Value
2. Risk Positioning
3. Regulatory Environment
4. Operating Environment
5. Financial Fundamentals

1. Corporate Governance
2. Controls
3. Financial Reporting Transparency
4. Credit Risk Concentration
5. Liquidity Management
6. Market Risk Appetite

- **Moody's analysts will formulate their opinion on CG based on our criteria, but also in light of IFSB's Exposure Draft on Corporate Governance at IIFS.**
- **We generally tend to consider the existence of Shari'ah Supervisory Boards as an additional layer within an IFI's CG infrastructure.**
- **As a corollary, we would put material emphasis on non-financial risks, including reputation risks (especially in the home and mortgage finance segment), and the risks of an IFI being perceived as not Shari'ah-compliant (enough), and therefore "unethical".**
- **See our recent report on this subject: "*Risk Issues at Islamic Financial Institutions*" Jan. 2008**

Displaced Commercial Risk (DCR) taken into the rating perspective

Notwithstanding such practical differences among IFIs in both combining funding sources and computing returns, "displaced commercial risk" is always at stake, giving birth to various mechanisms of smoothing returns. As demonstrated below, the practice of smoothing investment returns through "profit equalisation reserves", "investment risk reserves" and active management of *mudarib* fees is a very common feature of IFIs to avoid random, business- and confidence-driven liquidity crises. "Displaced commercial risk" (DCR) is indeed a term reflecting the risk of liquidity suddenly drying up as a consequence of massive withdrawals should the IFI's assets yield returns for PSIA-holders lower than expected, or worse, negative rates of profits. As a matter of fact, a negative return on PSiAs would not constitute a breach of contractual obligations, as PSiAs are supposed to absorb losses other than those triggered by misconduct or negligence, and therefore would not be considered a default. Nevertheless, default might be subsequently triggered by the very tight liquidity conditions the IFI would face in the case of massive runs on deposits. While this is in keeping with the risk-sharing principles encouraged by Islam, it remains to be seen how such account holders would react to losses on their accounts.

DCR is obviously taken into the analytical perspective, and is captured by Moody's analysts' assessment on both profitability and liquidity.

Managing DCR efficiently is a subtle dynamic exercise. Traditionally, there are four lines of defence:

Source: "Risk Issues at Islamic Financial Institutions", Moody's, January 2008

Moody's analysts are expected to formulate an opinion on an IFI's exposure to DCR and on the relevant available buffers to mitigate them: IRRs, *mudarib* fees, PERs and, ultimately capital.

Risk entanglement: another specificity captured in the rating process

Risk Management

The IFSB has recently published a standard for risk management in Islamic institutions, and this forms the basis for all discussions between Moody's analysts and bank management in this area. Islamic bank balance sheet structures indicate that there is a great diversity of classifications on both the asset and liability side, thus it is unlikely that there could be just one appropriate risk management approach. Therefore the IFSB has adopted a principles-based approach.

The IFSB standard lists 15 guiding principles for risk management in IFIs. There is a general requirement followed by those covering credit, equity investment, market, liquidity, rate-of-return and operational risks.

Source: "A Guide to Rating Islamic Financial Institutions", Moody's, April 2006

- **IFSB's "Guiding Principles of Risk Management" serves as the basis for rating discussions.**
- **We have recognized the existence of credit, market and operational risk entanglement in each Shari'ah-compliant financing contract (ijara, murabaha, mudharaba, musharaka, istisna' etc.).**
- **However, each contract type displays a dominant risk category, and therefore classified as part of the banking book (credit risk-focus) or the investment/trading book (market-risk focus) accordingly. This allows global financial comparability between banks, irrespective of their nature.**
- **Operational risk is usually treated as a separate subject.**

Analyzing an IFI's capital position

Moody's would prefer to look at a ratio that included all the assets funded by both restricted and unrestricted PSIA as well as all assets that are held on the balance sheet at this point in time. This preference is partly because of the lack of quantitative information on risks and losses, and partly because of the freedom banks have had to transfer assets on and off the balance sheet without disclosure. This is a conservative approach, but in general, Islamic banks are conservatively capitalised, therefore we do not expect many would require additional capital under this formula.

Source: "A Guide to Rating Islamic Financial Institutions", Moody's, April 2006

- **We understand the rationale behind, and the computation of, IFSB's Capital Adequacy Ratio (CAR) under its "Capital Adequacy Standard". This is as much as we do for Basel II's CAR calculations.**
- **However, for comparability purposes, we prefer to use our own conservative measures of capital.**
- **In this, we treat Islamic banks and conventional banks on the same analytical grounds.**
- **PSIAs are given no capital benefits.**
- **PERs have been given no formal capital benefits (yet); however, from a qualitative perspective, robust PERs would be viewed as a positive driver for scoring capital factors as part of the overall rating assessment.**

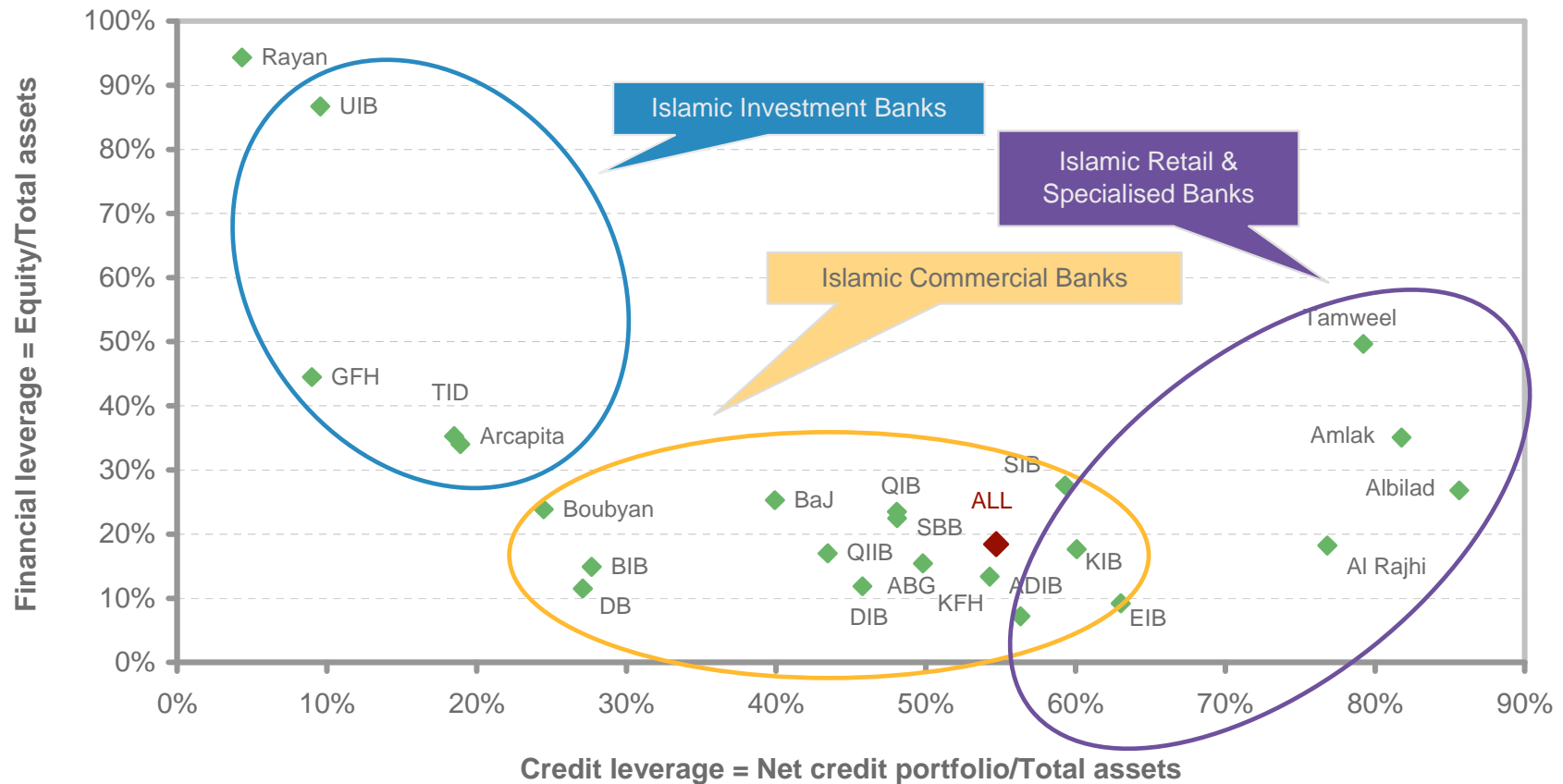


3. Islamic banking in the GCC: key trends and analytical findings



Growing specialization and business diversification of IFIs in the GCC

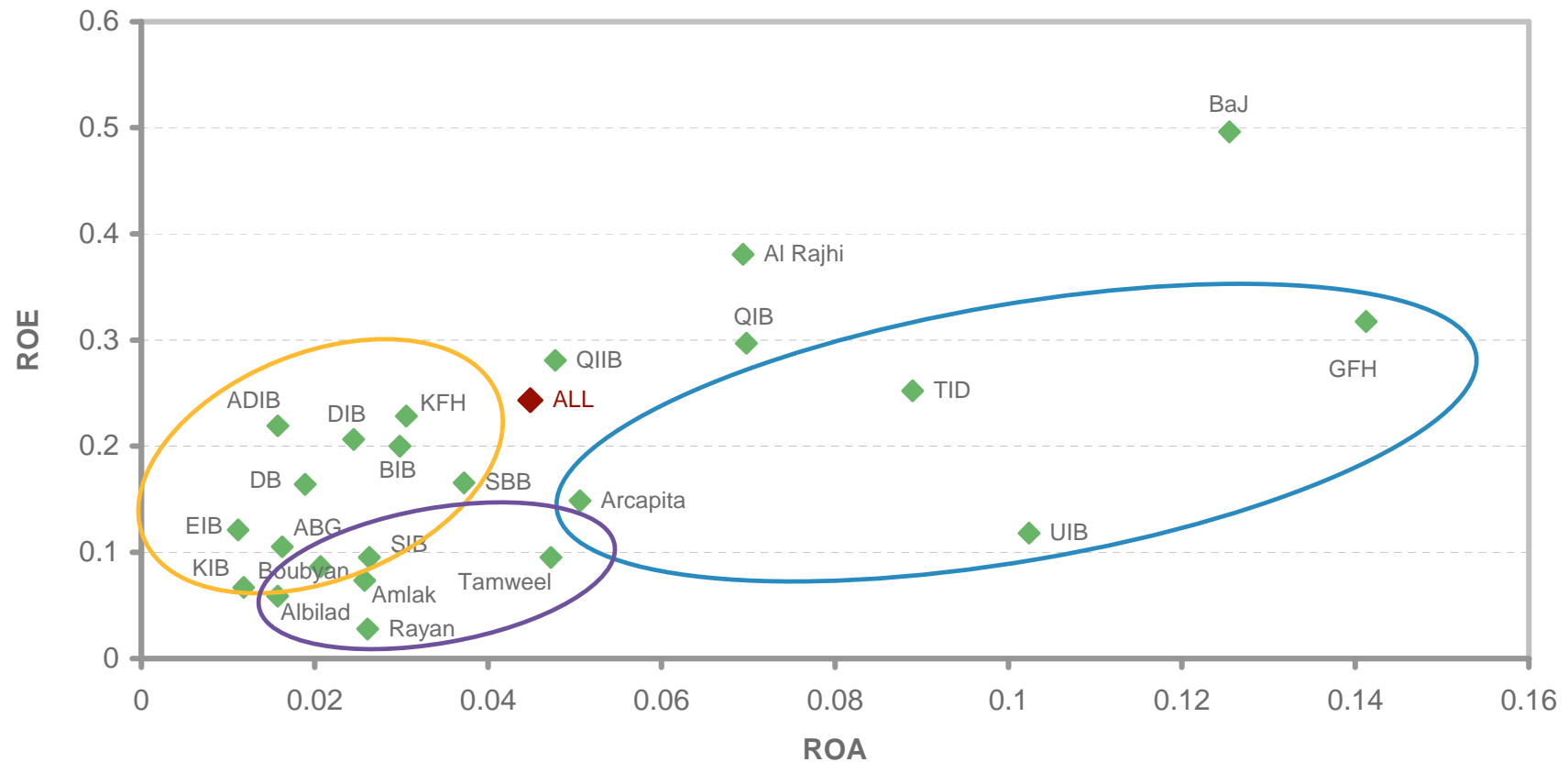
Credit vs. Financial Leverage Ratios for Islamic Banks Under Review (2006)



At Dec. 31, 2006

Growing specialization and business diversification of IFIs in the GCC (2)

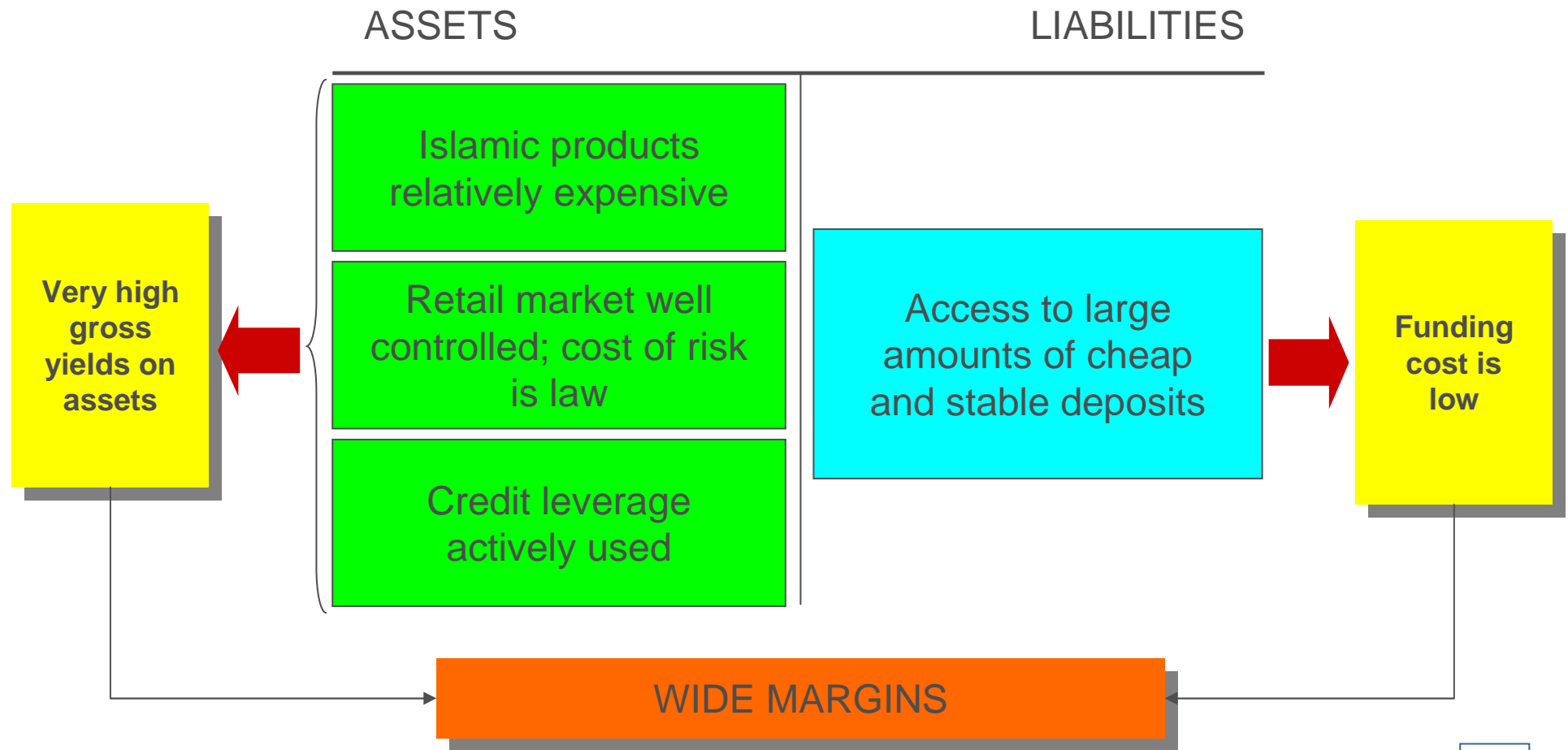
ROA vs. ROE for Islamic Banks Under Review (2006)



As at Dec. 31, 2006, excluding extraordinary income

IFIs are profitable and expected to remain so

High profit rates: some explanation



Islamic banks and sukuk: a close link

- Financial policies of Gulf states over the past 30 years has had **several objectives**: to bancarise, but also to disintermediate; to facilitate access to credit, but also to invest, thus strengthening refinancing mechanisms; ultimately, to develop Islamic financial markets as an alternative, for social and political reasons.
- However, **financial markets remain intermediated**. Banks still play a vital role in recycling petrodollar liquidity. Given their powerful entrenchment in *retail*, Islamic banks constitute an important compartment in capturing and reallocating financial flows in the Gulf.
- **Constraints are slowly emerging**: capturing ST deposits is used to book credit exposures with longer tenors, which increases maturity gaps poses serious ALM challenges, all the more so as Islamic banks can hardly use fixed-income instrument for B/S management...
- **One solution exists** : ① to include sukuk in banks' investment portfolios + ② issuing bank sukuk as funding tools.

Sukuk, oil, and global credit conditions...

- Islamic banks contribute **to the expansion of both demand and supply of sukuk**.
- « **Historic** » **sovereign sukuk**, serving as benchmarks, **were immediately absorbed**, and demand has switched to alternative issuers of sukuk (banks, corporates, and structured).
- **Demand being overwhelming compared to supply**, the sukuk market remains **very illiquid**: institutional investors prefer to stick to a « *buy-and-hold* » approach to investment in sukuk.
- The intermediated nature of Gulf financial systems creates indirect but powerful **correlation between oil prices on the one hand, and Islamic financial markets, including sukuk, on the other hand**.

Expectations for IFIs

As far as IFIs are concerned, we expect more:

- **Geographic diversification:** IFIs should continue to pursue their internationalization process, thanks to their robust domestic platform;
- **Operating diversification:** IFIs have become more aware of the necessity to widen their asset portfolios, especially in mortgages, Shari'ah-compliant securitization, and Islamic investment banking;
- **New entrants and competition:** the profitable Islamic banking market still attracts newcomers; and
- **De-correlation with oil prices:** the almost mechanical link between Islamic banking and oil prices, via the recycling of petrodollars in IFIs' home countries, should gradually decline.



4. Rating Sukuk

Moody's Credit Ratings are not..

- measure of liquidity
- measure of market value stability
- recommendation to buy, hold or sell
- *opinions on Shari'ah compliance*

A Moody's Rating equates to an Expected Loss or Credit Risk on a bond or note this is the:

Likelihood of Default x Loss given Default

Where credit risk is unaffected, Shari'ah compliance is for Scholars and Investors to decide, not Moody's

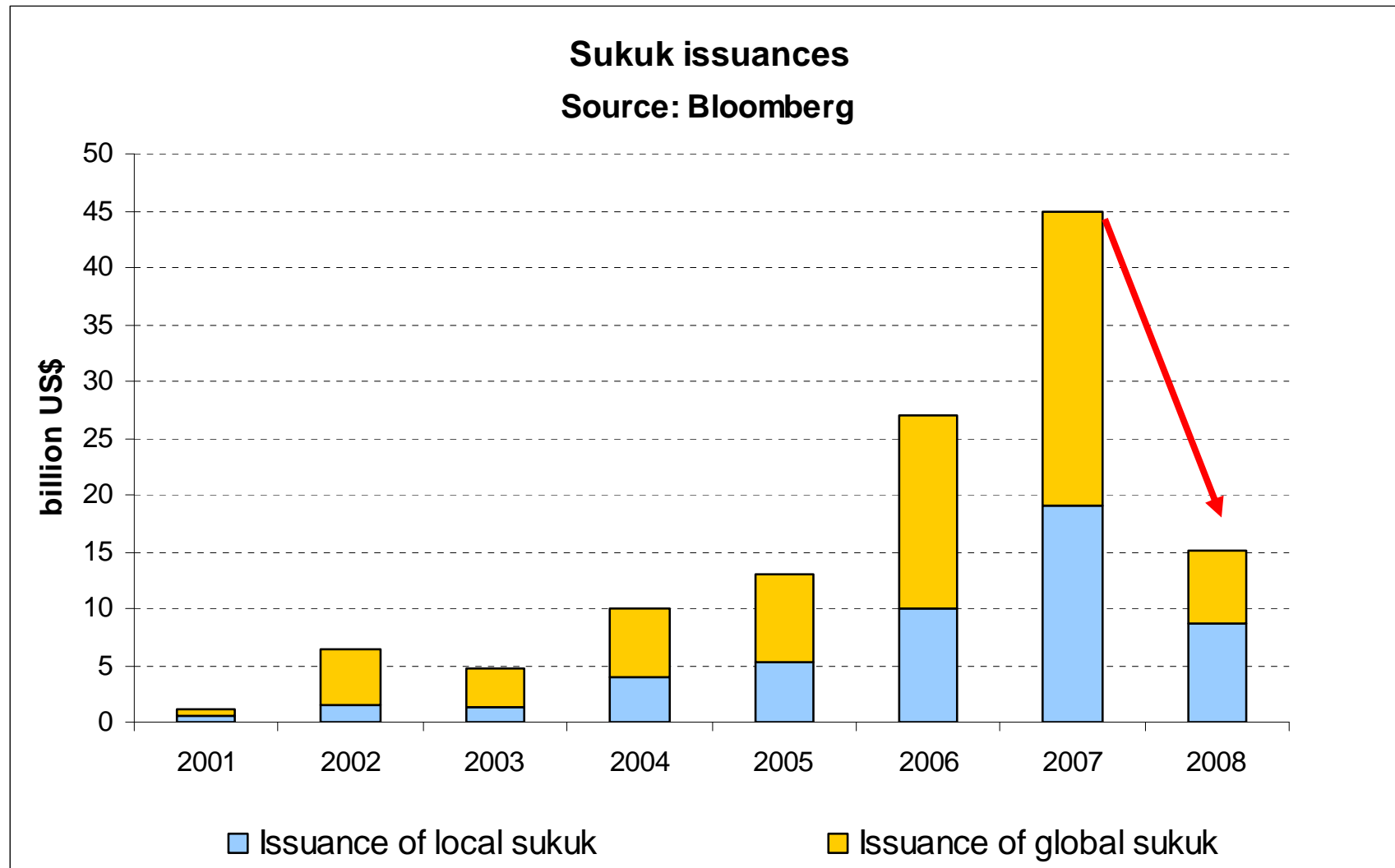
Is Islamic/Sukuk Risk Different?

***“Risk has no religion”* - GCC Central Banker**

- The risk/return profile of a Sukuk is still driven by the binding legal contracts governing the assets and associated cashflows..
- hence conventional methods of credit analysis can be applied, cashflow, risk and return are universal..
- but some may have new features which can affect the creditor’s position - these need to be critically assessed

Sukuk risk/returns still driven by the assets and legal structure – just like conventional bonds

Sukuk Market



Risk Analysis of Sukuk

- Sukuk can combine the various shari'ah contracts in various ways to create both asset-backed and unsecured financing structures..
- ...but beyond the Arabic terminology, the risk, return and rating analysis is the same – the details of the contract + assets
- Sukuk finance is an ethical / moral / halal subset of the universe of conventional finance
- However as seen not all conventional contracts have Shari'ah counterparts, not all conventional structures encourage asset ownership so strongly –there are issues of **'form' over 'substance'**

Islamic Creditors – A Stronger Position?

- The tangible, secured, asset ownership favoured by Shari'ah would ordinarily strengthen their creditor position in a liquidation/insolvency scenario...
- ...but in most Sukuk such rights/transfers are not (in Asset Based) contractually effected with the Sukuk. The corporate's 'aim' is to have an unsecured risk profile
- ...the complexity of Sukuk does however need deeper analysis to ensure the credit risk is equivalent to regular bonds

In majority of issuance Sukuk investors are usually pari-passu with conventional bonds of the same rank

Islamic Securitisation?

- 'Usury' is prohibited – this is broadly interpreted as interest, thus generating profit from debt forbidden
- 'Borrowing' for non-specific purposes is generally discouraged, funding for a particular venture better
- Shari'ah 'ideal' may favour equity, but genuine asset-backed structures are much closer this ideal than the majority of existing Sukuk
- AAOIFI comments try to discourage the 'effective' 100% borrower recourse of existing Sukuk

The tangibility and specific nature of securitisation lends itself well to Shari'ah financing principles

Some Shari'ah driven risk considerations

■ **Currency Hedging**

- Compliant swaps in their infancy, proposals reviewed were not equivalent to ISDA standards in mitigating counterparty risk

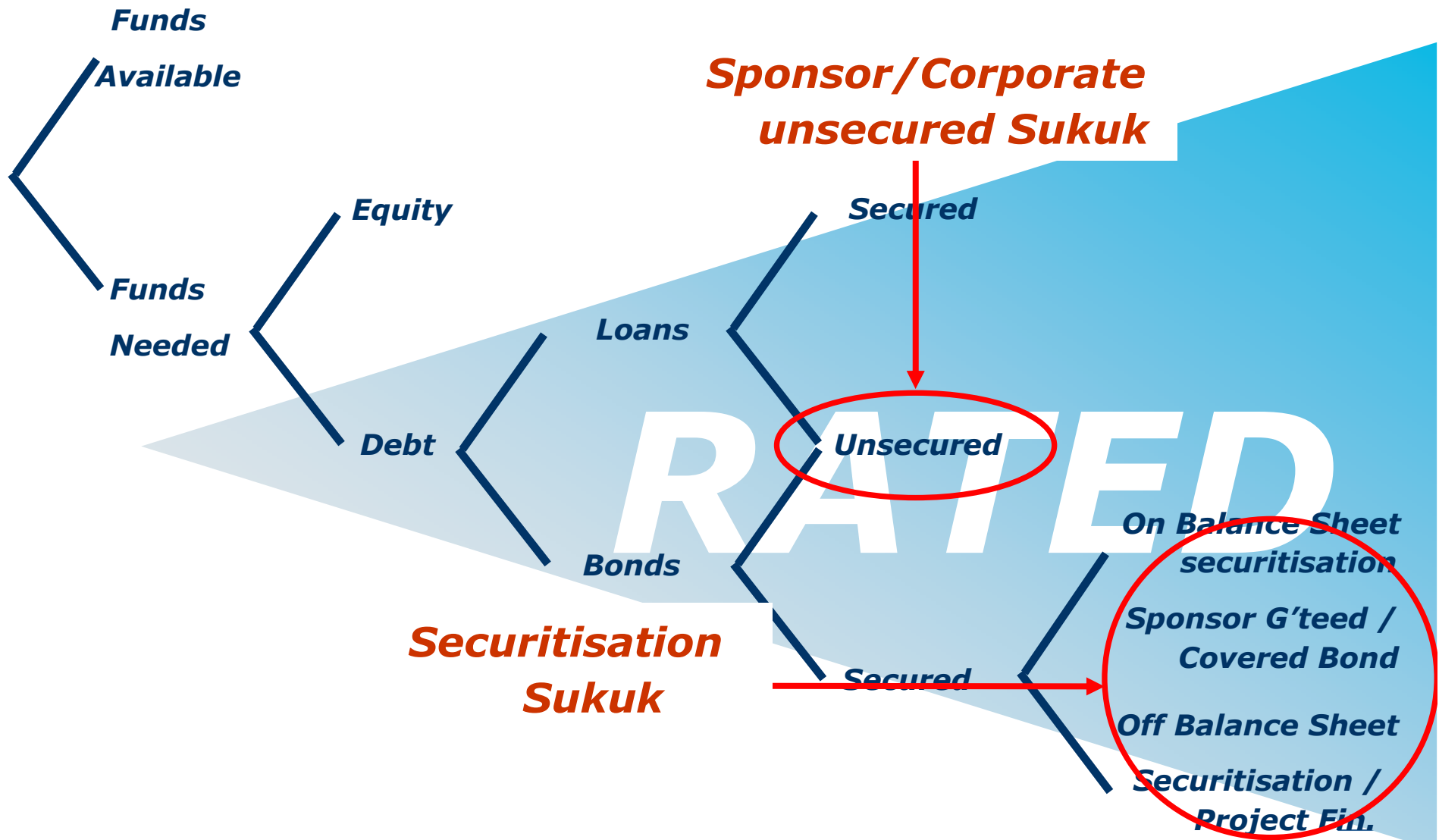
■ **Liquidity Provision**

- Can be seen as a sponsor guarantee, Shari'ah desire to make it discretionary would place Sukuk holders in a weaker position where feature such is required for 'profit' [coupon] maintenance

■ **Asset Ownership**

- For financings that are 100% Sukuk, actual registration of asset (s) in SPVs name can strengthen Sukuk creditor position in an uncertain [emerging market] insolvency regimes

Where are Sukuk Bonds?



Summary (1/2)

- **Risk, Return & Rating Profiles can match Conventional**
 - Overall structure may be different but the risk, return and credit analysis is based on same fundamentals.
 - Islamic creditors likely (by design) to be pari-passu to Conventional by design in most Sukuk. Both investor groups can participate in Sukuk
- **Shari'ah and Securitisation are natural partners**
 - Tangibility and specific application of funds makes it well suited for Sukuk structures

Summary (2/2)

| Sukuk Category | Features | Rating approach |
|---|--|---|
| <p>Unsecured asset-based sukuk</p> | <p>Sukuk are unsecured by the pool of underlying assets, but the principal is guaranteed, usually by the originator of underlying assets, via a purchase undertaking agreement. Coupons (Periodic Distribution Amounts) are protected by a liquidity provision supplied by the originator-guarantor.</p> | <p>Sukuk ratings are equalized with those on similar obligations of the same obligor, ranking <i>pari passu</i>. If the sukuk are senior unsecured obligations, then the ratings on the sukuk will be equivalent to the issuer's counterparty rating in the relevant currency. Otherwise, in the case of subordinated sukuk, ratings are notched down. Fundamental rating methodologies are applied.</p> |
| <p>Secured asset-backed sukuk</p> | <p>Principal and coupons payments depend on the cash flows derived from the pool of underlying assets, and on the structure of the transaction. Sukuk here are usually "tranching" in various classes, where credit enhancement mechanisms are inherent to the repackaging structure of the sukuk.</p> | <p>Structured finance criteria and methodologies are applied, with adjustments taking into account the structural features of the jurisdiction out of which sukuk are issued. The quality of the cash flows derived from the pool of underlying assets constitutes the most critical rating factor; along with the specificities of the transaction's structure, the economic behaviour of the pool will determine the size of the various sukuk classes per rating category.</p> |

Some Expectations

- **Innovation**, Sukuk structures continue to evolve based on needs of borrowers and investors;
- **Volumes**: Once markets normalise, Sukuk market should resume an average growth of 30% p.a. in the next five
- **Securitisation**: The 'truly' asset backed nature of these financings means they are well suited to Sukuk
- **Liquidity**: More issuance means more market liquidity, and hence more efficient disintermediation in Islamic capital markets.

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