Takaful and retakaful players, although established for some time now, have achieved critical mass only in the past few years, during which we have witnessed increasing interest and acceptance of their business model. Attesting to this is these insurers’ reported rapid growth in gross premiums written, which we believe is driven by consumers switching from conventional insurance or entering the takaful market for the first time, including for life takaful products; the differences in conventional and takaful insurance products; a widening range of takaful business lines; and legislative changes favorable to takaful insurance activity. We note that this growth, combined with a stable claims environment, has provided takaful and retakaful operators with a steady cash inflow through which to settle claims.

Claims settlement appears further supported by operators’ liquid investment portfolios in both participant and shareholder funds. The liquid investment portfolios reflect the largely short-term nature of their business. Investment portfolios’ assets range from low-risk murabaha (bank term deposits) to high-risk nonlisted equities, but we believe they currently comfortably exceed net outstanding claims. For this to continue to be the case, however, markets must remain liquid enough to allow the pricing of such assets. Credit risk, through market volatility and uncertainty in asset pricing, could lead to reduced earnings in the takaful segment, with lower investment income combined with high use of reinsurance protection—both regional and international—for certain risks. However, takaful and retakaful insurers’ generally adequate-to-strong capital adequacy relative to risks written is, in our opinion, a significant compensating factor.
Risk Management For Islamic Financial Institutions: A Rating Perspective

Analyzing different risk categories and their management is a critical step in assessing the creditworthiness of all types of banks. Overall, there is no material difference between our analysis of the risks and enterprise risk management of Islamic banks and of conventional ones. However, the former display unique features—relating to credit, market, funding and liquidity, and other risks—that need to be considered and which have an impact on our rating process. Profit-sharing investment accounts (PSIAs), liquidity management, real estate exposure, and operational risks are among the elements that we focus on when assessing the creditworthiness of an Islamic financial institution (IFI).

Over the past decade, Standard & Poor’s Ratings Services has developed strong expertise in the field of Islamic finance. We have adapted and refined our rating methodology to address the specifics of operations carried out by IFIs. It is important to note, however, that our opinions relate only to the creditworthiness of an IFI or a specific debt instrument, not to its degree of compliance with Sharia.

**Credit Risk: First Lien Access To Collateral But Foreclosure Is Difficult**

One of the five pillars of Islamic finance (see appendix), the obligation to back any transaction by a tangible, identifiable, underlying asset, means that IFIs—at least in theory—back their transactions with collateral. Consequently, collateral coverage is usually higher for IFIs than for conventional banks.

Contrary to conventional banks, whose customers are not obliged to disclose the purpose of their borrowings, Islamic banks finance the acquisition of identifiable assets of which they have legal ownership, in most cases, until maturity and final repayment. This is notably the case for “ijara” (lease financing) operations, in which the bank acquires the asset and leases it to the customer, with ownership transfer taking place only at maturity. The bank, as the legal owner of the asset, is therefore in a favorable position to foreclose on this asset (in the case of a default), and sell it on a secondary market.

In practice, however, collateral foreclosure can be much more difficult, especially for residential real estate. Given the take-off in residential real estate lending in Gulf Cooperation Council (GCC) countries, this question of foreclosure is set to become critical (including for Sharia-compliant securitization). Although an Islamic bank is in theory 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, this would be unlikely to happen in practice owing to its “social responsibility.”

There are, however, instances when such a decision may be taken by a bank and authorized by its Sharia board—notably when specific conditions were set out and agreed upon 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. As a matter of fact, this type of structuring is sometimes used by conventional banks, as it is a strong way of reducing the problem of foreclosure. However, when the financing is based on other Sharia-compliant schemes where the property is not registered in the bank’s name, the IFI will find itself in the same position as its conventional peers.

Certain transactions carried out by Islamic banks can bear above-average credit risk. For instance, some Islamic banks are involved in “musharaka” (venture capital financing) and “mudaraba” (trust financing), which are equivalent to participation transactions, increasing
the risks carried by the bank. In addition, in “murabaha” (mark-up financing) and ijara, the existence of full collateral could lead Islamic banks to be less vigilant when assessing the creditworthiness of their borrowers.

The credit risk of an IFI can also be influenced by the way its operations are funded. Under Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) reporting standards, there is a clear separation between assets financed through equity and assets financed through PSIs. One example of this can be found in the financials of Shamil Bank of Bahrain. In the case of a default on some assets financed through PSIs, the holders are, in theory, supposed to share in the losses. Thus, funding a loan portfolio through PSIs could be viewed as a partial transfer of credit risk from an IFI to PSA holders. However, in practice there is a strong incentive for the bank to take the hit through a reduction of its “mudarib” fee (for acting as a manager of PSIs) or through its reserves. Indeed, a loss could trigger some PSIA holders to withdraw their funds, which could translate into liquidity problems. Standard & Poor’s believes that IFIs would be inclined to support PSIA holders in the case of issues related to the credit quality of the underlying portfolio. Therefore, the loss-absorbing nature of these instruments is not completely certain.

**Market Risks: Structured Products Are Generally Forbidden And Hedging Instruments Are Limited**

The management of market risks is made more difficult for Islamic banks due to the limited number of risk management tools/instruments available to them. For example, it is difficult for an IFI to use hedging instruments such as derivatives as they are generally forbidden. On a positive note, the prohibition of “gharar” (speculation) usually tempers the risk profile of Islamic banks simply by limiting the size of their trading operations. Market risk for IFIs can be divided into three categories:

- **Margin risk.** This results from a mismatch between the yield earned on the bank’s assets and that served on its liabilities. For instance, a bank can find itself exposed to margin risk when a portfolio of murabaha (with fixed margins) is financed through PSIs (with variable margins). As Islamic scholars usually forbid recourse to derivatives, this risk can be difficult to hedge. In some cases, IFIs can employ nascent Sharia-compliant hedging techniques. Dubai Islamic Bank (DIB) and Deutsche Bank AG have stated that they have established the first ever Sharia-compliant profit rate collar. For less sophisticated IFIs, the matching of floating and fixed yields can be used as a natural way to cover these risks. An ijara portfolio—with a floating margin or repricing characteristics—could be used to reduce an IFI’s exposure to margin risk resulting from the use of PSIs as a funding source. As IFIs usually benefit from a large portion of unremunerated deposits, as is the case for Saudi Arabia-based Al Rajhi Bank, this can also be a good mitigating factor for margin-related risks.

- **Investment risk.** IFIs are forbidden from speculating, which means that trading risk is limited. In addition, as most complex structured products are usually not considered Sharia compliant, IFIs cannot invest in them. The exposure of IFIs to investment risk is therefore limited to that stemming from equity markets. Sharia-compliant debt products (such as sukuk), and real estate. Given that the secondary market for sukuk is very limited, the risk relating to these instruments mainly stems from credit quality rather than from market movements. Although IFIs that invest in stock markets are exposed to swings in equity prices, direct exposure to these markets is usually limited. We have seen some opportunistic investments made by IFIs over the past three years in order to benefit from the boom in GCC stock markets, but the correction that took place in 2006 provided a strong incentive to limit these exposures. IFIs are usually significantly exposed to the real estate sector, as it is compliant with Sharia principles. Some Islamic banks in the GCC have significant
exposure to this sector (directly or indirectly through collateral), which is negatively factored into our ratings. DIB is an example of such a bank, with significant direct and indirect exposure to real estate.

- Foreign exchange risk. As for conventional banks operating in emerging markets, IFIs’ exposure to foreign exchange risk can be harmful. While conventional banks can easily hedge themselves through swaps or other hedging instruments, these are generally forbidden in Islamic finance, making the situation more challenging for IFIs. For the time being, this risk is limited for banks operating in GCC states as their currencies are pegged to the dollar (except for Kuwait).

**Funding And Liquidity Risk: PSIAs Are A Unique Feature Of Islamic Banks**

Liquidity is one of the most critical issues for IFIs, as only a small secondary market exists to enable them to manage their liquidity. Their assets are generally not sellable on a secondary market and they cannot invest in fixed-income instruments for treasury management purposes. This fact is all the more damaging for them as, in the Gulf region, sovereigns have been using local and foreign currency conventional debt as a means of actively managing their financing needs, and non-Islamic banks have been major subscribers as returns have been attractive. A key development in this area has been the formation in Bahrain, in 2002, of the International Islamic Financial Market (IIFM), whose aim is to create and standardize financial instruments to meet the liquidity needs of IFIs around the world. In addition, some leading Islamic banks have set up bilateral agreements with their respective central banks in order to address this weakness. This is notably the case for Al Rajhi Bank, which has an investment portfolio that can be repoed with the Saudi Arabia Monetary Agency (SAMA).

Many Islamic banks offer PSIAs to their customers. These financial instruments are relatively similar to the time deposits of conventional banks. The terms and conditions of PSIAs provide for depositors being entitled to receive a share of the bank’s profits, but also obliged 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 and one of the five pillars of Islamic finance (see appendix). It translates into a displaced commercial risk, however, and could result in a liquidity stress should PSA holders decide to withdraw their deposits at maturity. This risk could be triggered by the inability of an IFI to provide these depositors with returns that are relatively similar to competitors’ (conventional or Islamic). Several layers of protection have been developed by some IFIs, however:

- Profit equalization reserves (PERs). These reserves constituted by IFIs can be used to smooth returns offered to PSA holders in cases of reduced distributable cash flows. For instance, if an Islamic bank realizes an effective profit that is not sufficient to offer its PSA holders a satisfactory return, it could use part or all of its PER to boost the return and maintain its deposit base. PERs are deducted from a bank’s gross profit before allocating the mudarib fee.

- Mudarib fee. This is the remuneration of the bank for acting as a manager (mudarib) of PSIAs. The mudarib fee is not fixed and differs from one bank to another, but is typically between 20% and 40% of the distributable cash flows. This can provide a bank with some room for maneuver in case of unexpected profitability deterioration; it could simply decide to waive its fee, allowing a higher remuneration to PSA holders.

- Investment risk reserves (IRRs). These are reserves constituted by IFIs in order to curb the risk of future unexpected losses and enable them to be in a position to support PSA holders should such losses occur. IRRs are set aside by IFIs after allocating the mudarib fee.

- Liquidity. IFIs offering PSIAs are in general more liquid than conventional banks as they are aware that their reliance on PSIAs could trigger liquidity stress. The average liquid-to-