The Relevance of Rating a Sukuk
Final Part: The Credit Ratings Agencies’ Perspective

By Islamic Financenews

In the first two parts of this focus, Islamic Finance News obtained views from market players on the advantages and disadvantages of rating a Sukuk as well as the effectiveness of credit rating agencies. The majority agreed that a credit rating was essential but felt a need to regulate these credit rating agencies. Some players had even suggested that regional rating agencies be set up by regulators to ensure that the ratings are not seen to be biased towards the issuers which engage the agencies.

Islamic Finance news’ focus on the relevance of rating a Sukuk therefore would not be complete without getting responses from the two largest international credit rating agencies — Moody’s Investors Service (Moody’s) and Standard & Poor’s (S&P).

Khalid Howladar, vice-president and senior credit officer in the structured finance group at Moody’s (pic), said investors benefit from a rated Sukuk as it is a third party’s opinion about the credit risk of the issuance. “Investors in an unrated Sukuk have less information available to them about the performance of a Sukuk,” he said, adding that a Moody’s rating has historically been a good indicator of credit risk.

S&P did not steer far from Moody’s view, stating that ratings provide investors with an independent opinion on the relative creditworthiness of issuers and issues, both conventional and Islamic. “During the rating process, we receive confidential information from the issuer in order to formulate our opinion, but our ratings are only carried out at the request of the issuer. A credit rating does not represent investment advice and is not an indicator of market liquidity, but it is one of the factors investors may consider when making investment decisions,” S&P said.

Both credit rating agencies said the Accounting and Auditing Organization for Islamic Financial Institution’s (AAOIFI) pronouncement — that a capital guarantee cannot be included with a purchase undertaking in a Sukuk structure — does not have any effect in rating a Sukuk. “In the case of Moody’s, this would not pose a problem at all. We have a vast amount of expertise in analyzing the risks of asset-backed structures and in cases where there is no corporate guarantee, the investor is taking the risk of the Sukuk assets — not that of the company,” Howladar explained. S&P said that from a rating perspective, it does not comment on the Shariah compliance of issuers or issues, or factors it into its analysis. “Our methodology enables us to rate Sukuk with full credit enhancement mechanisms (commonly called ‘guaranteed’ Sukuk) and Sukuk with no or partial credit enhancement mechanisms,” it stated.

Asked whether a Sukuk should be rated, both rating agencies were affirmative. Howladar replied that while investors are encouraged to perform their own due diligence, a rating provides investors with an additional opinion about the credit or default risk of a Sukuk. “Moody’s ratings allow investors to make an informed decision before investing in a Sukuk. Moody’s ratings are public for all investors to see,” he added. S&P responded in like, saying that while a rating provides investors with independent and objective opinions about relative creditworthiness of an issuer, “ratings are only carried out at the request of an issuer and ultimately, the decision to seek a rating rests with them.”

In the second part of the article, the majority of the market players approved of a credit rating for a Sukuk. However, there are those who viewed otherwise. When this was brought to their attention, both rating agencies stressed that credit ratings add value to the issuance, the issuer and investor as well.

“Indeed, rating is not a requirement but it may offer many obvious benefits such as improved transparency, the potential for greater liquidity and a wider investor base,” said Howladar. S&P added: “Debt markets in the Middle East have developed significantly over the past five years, with more local issuers accessing international capital markets to secure long-term funding (both Shariah compliant and conventional). “As a rating agency, we believe we can add value to local and international investors through our long history and expertise providing independent opinions on creditworthiness and by creating transparency. The capital markets in the Middle East and Sukuk are still at a relatively nascent stage and we expect the request for ratings to increase going forward.”

While S&P declined to comment on whether pricing is the only consideration for a Sukuk to be rated, Howladar believed that ultimately, the most important driver is the investors’ need for a globally acceptable and trusted opinion on the credit risk.

Some market players have commented that the methodology of rating a Sukuk is similar to that of a conventional bond. S&P provided a detailed explanation on the matter. It conceded that it applies the same definition of default to Sukuk as it does to conventional debt securities, which is the inability to fulfill financial obligations when they are due.

Having said that, it does distinguish between three types of Sukuk:
• Those with full credit enhancement mechanisms where, in most cases, the rating depends on that of the sponsor.
• Those with no credit enhancement mechanisms, where the rating depends on the capacity of the underlying assets to generate a sufficient inflow of cash to fulfill the financial obligations of the issuer.
• Those with partial credit enhancement mechanisms, where the rating depends on a combined approach of assessing the creditworthiness of the Sukuk (without taking into account these mechanisms) and then reflecting them by adding notches of support, depending on the extent and the creditworthiness of the entity issuing them into account.

“With the exception of sukuk with full profit and loss sharing mechanisms, when that occurs, it is important to note that S&P is the only rating agency that has launched the ‘stability rating’ applied to Profit Sharing Investment Accounts (PSIAs). A stability rating gives an independent opinion on the sustainability and variability of the cash flows underpinning distributions to PSIAs’ holders,” it stated.

Haldadar approached this issue by saying that most of the recent Sukuk were indeed conventional bonds despite being based on the continued...
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concepts of Ijarah, Musharakah, Mudarabah and others, so there is a need to question the value to Islamic finance of a Sukuk that is identical in terms of risk and return characteristics as a conventional bond. “Greater transparency is needed and a focus on the structures and business models that make Islamic finance different from, rather than mere replications of, conventional finance,” he said, adding that those issues were comprehensively addressed in Moody’s special comment entitled “The Future of Sukuk: Substance over Form?”, published in May 2009.

Asked whether the methodologies of credit rating agencies should therefore be standardized, Howladar said that having different approaches provides a significant benefit for investors and regulators. S&P termed the difference as “healthy” as it provides the market with different perspectives and enhanced competition. “We believe the key issue for market participants is that there is transparency, clarity and consistency on how we reach our decisions,” it said.

The global economic crisis not only brought the downfall of many huge financial institutions in the conventional markets but also criticisms of the credit rating agencies which had awarded them highly favorable ratings, especially in the collateralized debt obligation (CDO) market. Also there was criticism of their inefficiency in downgrading a company promptly. How would this translate for the Islamic finance industry? Both rating agencies said their reputation in the Islamic space precedes them. Howladar explained that as Moody’s has been rating bonds for over 100 years, this translated into its extremely good performance history that is a generally good “indicator.”

“However, ratings are not facts but opinions and should be treated as such. We have taken note of many ideas and requests put forward by market participants and will, where appropriate, incorporate them into our analysis going forward. We take pride and responsibility in being as accurate as possible, but no one can predict the future with absolute certainty. “It is up to the investor to decide whether to invest purely on the basis of their own analysis or whether to consider Moody’s opinion as well. I see no gap in the Islamic finance industry — indeed, our ratings are probably even more valuable to investors in this sector because of the immaturity of the market and relative lack of transparency in some of the countries where this industry is growing,” Howladar said.

On a proposal that credit rating agencies be regulated, Moody’s and S&P fully supported the move, pointing out that they are already being regulated in the various jurisdictions where they have a presence. “Moody’s believes that regulation should be globally consistent when it is applied and that it should contribute to the goals of enhancing the transparency and accuracy of the ratings process,” Howladar commented. S&P regards regulation of rating agencies as an important factor in restoring confidence in the financial markets and its participants. “We welcome proposals that would, on a globally consistent basis, increase transparency and preserve the analytical independence of rating agencies’ opinions and analytical processes,” it said.

S&P added that rating agencies have undergone extensive scrutiny by the market. It said its procedures and policies are already subject to direct oversight by the US Securities and Exchange Commission while in November last year, the European Commission tabled a draft regulation on credit rating agencies which was approved by the European Parliament on the 23rd April this year and is expected to come into force in October.

“Our own initiative, S&P has already adopted a broad range of measures to enhance the transparency, independence and analytical quality of ratings, including appointing an ombudsman and providing more information to investors about the assumptions and stress tests behind its ratings opinions. Analytical enhancements introduced in recent months include incorporating credit stability (not just ultimate default risk) in its analysis and additional measures to assess the data quality capabilities of issuers,” it explained.

Another comment by market players is that credit rating agencies’ ratings and analyses do not truly reflect local market conditions as they focus on the macro conditions instead of the micro. Both rating agencies disagreed, insisting that they have “zeroed in” on the local markets, especially in the Middle East and Asia, when providing ratings or analyses. Howladar said Moody’s strives to continue making greater efforts to involve itself in the local markets in order to understand them better. “We have sizable analytical staff based in the Middle East and Asian regions. Although we are a global company, we are very locally focused while bringing best practices from more mature markets. In the Middle East, a region relatively new to ratings, Moody’s opinions have received much attention because the market trusts our opinion to be objective and unbiased,” he contended.

S&P voiced a similar opinion: with its long history of providing ratings to various regions, it has developed an in-depth skill base, employing analysts from the region who understand the local culture and environment. This strengthens its ratings in being globally consistent and internationally recognized as it factors in local market circumstances based on its global criteria.

“Our analysis and methodology reflect both the macro and the micro perspectives of the market. The ongoing surveillance and discussions with issuers and other third parties such as regulators and central banks ensures that we continue to keep our opinions up to date by including local information in this process,” it said, surmising that S&P is therefore able to reflect changes in underlying creditworthiness in its ratings.

S&P also mentioned its recently launched ASEAN regional rating scale, recognizing the need of both investors and issuers. “We continue to ensure that we have robust criteria and provide independent opinions that serve the information need of investors,” it said.

Howladar asserted that Moody is an integral part of the Islamic finance industry, in addition to having observer member status on the Islamic Financial Services Board. “We rate 10 Islamic banks and over US$20 billion of Sukuk and publish a significant amount of relevant research for the benefit of the Islamic finance industry, and are helping to bring it up to world class standards in terms of risk transparency,” he stressed, adding that Moody’s local offices work together with its global network to ensure best practice and thorough analyses.

Asked whether there are too many credit rating agencies in the market, with a recent report indicating that the figure stood at 68 as of last year, S&P considered the competition to be healthy while Howladar said Moody’s believes the market would benefit from a diversity of viewpoints.

“As long as the market and regulators differentiate between varying approaches to rating Sukuk, then having more rating agencies is good for investors. If investors and regulators don’t differentiate, then ‘window shopping’ for a rating becomes much more likely,” he added.