ISLAMIC FINANCIAL SERVICES BOARD

GUIDANCE NOTE IN CONNECTION WITH THE CAPITAL ADEQUACY STANDARD: RECOGNITION OF RATINGS BY EXTERNAL CREDIT ASSESSMENT INSTITUTIONS (ECAIs) ON *SHARĪ`AH*-COMPLIANT FINANCIAL INSTRUMENTS

March 2008

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ACRONYMS

CAS	Capital Adequacy Standard
CDR	Cumulative default rates
CEBS	Committee of European Banking Supervisors
CRD	Capital Requirements Directive
DCR	Displaced commercial risk
ECAI	External credit assessment institution
EL	Expected loss
EU	European Union
IAH	Investment account holders
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering only Islamic financial services (excluding (a) Islamic insurance (*takāful*) institutions and (b) Islamic mutual funds)
LGD	Loss given default
PD	Probability of default
PER	Profit equalisation reserve
PSIA	Profit-sharing investment accounts

Bismillahirrahmanirrahim

Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

OBJECTIVE

The objective of this Guidance Note is to outline criteria which the Islamic Financial Services Board (IFSB) recommends national supervisors should take into account when determining which external credit assessment institutions may have their ratings used to calculate capital adequacy ratios under the IFSB's December 2005 Capital Adequacy Standard. The IFSB also hopes that the Guidance Note will promote a wider debate on key points of rating methodology for *Sharī`ah*-compliant instruments.

SECTION 1: BACKGROUND

1. The Capital Adequacy Standard (CAS) issued by the Islamic Financial Services Board (IFSB) in December 2005 addresses, *inter alia*, the structure and contents of *Sharī`ah*-compliant products and services that are not specifically addressed by the Basel Committee on Banking Supervision in the document "International Convergence of Capital Measurement and Capital Standards" (commonly referred to as "Basel II"), and seeks to standardise the approach to risk weighting such products and services.[1] In this way, it provides a common basis for institutions offering only Islamic financial services (IIFS) [excluding Islamic insurance (*takāful*) institutions and Islamic mutual funds] – whose capital structure and assets may differ in nature from those of financial institutions addressed by Basel II – to calculate their risk-weighted capital ratios.

2. The CAS states that one input which may be used to determine the risk weightings of *Sharī`ah*-compliant assets is the credit ratings assigned to them by eligible external credit assessment institutions (ECAIs – commonly known as "rating agencies").[2] The CAS also states that IIFS shall refer to their supervisory authorities to identify ECAIs whose ratings may be used for this purpose.

3. Like Basel II, the CAS states that under the Standardised Approach to the assignment of risk weightings in calculating their capital ratios, which most if not all IIFS are expected to adopt, the IIFS may use credit ratings issued by ECAI.[3] This implies that national supervisory authorities will delegate to ECAIs an important role in the calculation of IIFS' capital ratios. The question therefore arises as to which criteria and processes the supervisory authorities should use to recognise ECAIs so that the rating agencies perform this role in a manner that will satisfy the supervisory authorities.[4]

4. Basel II suggests six criteria which ECAIs should satisfy if their ratings are to be recognised by supervisory authorities for the purpose of calculating risk weightings. These criteria are: objectivity, independence, international access/transparency, disclosure, resources and credibility.[5]

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[1] CAS, paragraph A.2.

[2] CAS, paragraph 20.

[3] The term "IIFS" refers not only to institutions whose operations conform in their entirety to the *Sharī`ah*, but also to conventional institutions that offer *Sharī`ah*-compliant products and services in addition to those which are conventional. A conventional bank that has exposure to *Sharī`ah*-compliant assets may wish to use ratings by ECAI's recognised in line with this Guidance Note to determine risk weights for those *Sharī`ah*-compliant assets, while using ratings by other ECAIs to determine risk weights for its conventional assets.

[4] The recognition, by national supervisors, of an ECAI in this way does not constitute a generalised licensing of the ECAI. The sole purpose of such recognition is to permit the use of an ECAI's ratings by IIFS seeking to calculate their capital adequacy positions.

[5] Section II.B.2 (page 27) of the June 2006 Comprehensive Version.

5. The Basel II criteria are a set of generally acceptable principles for ECAI recognition, but Basel II states that national supervisors are responsible for determining whether an ECAI in fact meets those criteria and is eligible for recognition.

6. Basel II leaves to national supervisors the task of determining the precise criteria that will govern ECAI eligibility within their jurisdictions, as well as the process by which an ECAI is to be recognised. National supervisors therefore retain ultimate discretion over ECAI recognition. It is expected that they will provide a set of detailed recognition criteria to which applicant ECAI can respond, as well as defining a process by which such recognition will take place.

7. The European Union (EU) has issued a directive – the Capital Requirements Directive (CRD)– which requires EU members to implement Basel II within their own jurisdictions.[6] The CRD uses the six Basel criteria as a base upon which to specify its own – more comprehensive – criteria, which supervisory authorities in EU countries should use in recognising ECAIs for the purpose of Basel II. Although the CRD provides *criteria* for determining eligibility for recognition, it is silent on the *process* by which such eligibility is conferred.

8. The Committee of European Banking Supervisors (CEBS) has produced a set of guidelines, including recognition criteria, which are more detailed than those in the CRD, as well as a process through which eligibility may be established.[7] The CEBS Guidelines include a "Common Basis Application Pack" detailing the information that an applicant ECAI should provide to establish its eligibility. While actual recognition remains in the hands of national supervisors, in practice national supervisors are using approval by CEBS to establish eligibility within their own jurisdictions.[8] Such an approach has the additional benefit of reducing the regulatory burden on ECAI, since through the provision of a single package of information to a single body they are able to progress some way down the road to recognition by multiple supervisors.

9. One feature of the CEBS Guidelines is that they identify three distinct asset classes which are rated by ECAI: structured finance, public finance and commercial entities. CEBS expects that ECAIs will have a dedicated rating methodology for each asset class in which they are seeking to have their ratings recognised for the purposes of Basel II capital calculation. So, for example, an ECAI could apply to have its ratings on public finance and commercial entities recognised, but not its ratings on structured finance. CEBS makes this distinction because it believes that ECAIs use separate methodologies for each of the three asset classes.

10. In the same spirit, this Guidance Note asserts that *Sharī`ah*-compliant financial assets should be regarded as a set of asset classes with distinct characteristics, and that therefore ECAIs should incorporate in their rating methodologies an explicit understanding of these distinct characteristics and provide detailed and clear explanations of how these are addressed, as a condition for their ratings to be recognised for the purpose of IFSB CAS capital calculations.[9]

11. Rating analysis of *Sharī`ah*-compliant assets may differ from analysis of conventional assets, both in terms of the general principles that govern *Sharī`ah*-compliant finance (for example, the concept of default) and in terms of the features of specific financial instruments (for example,

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[6] The CRD was adopted by the EU Commission in June 2006, and member states started implementing it from 2007, with the most sophisticated approaches being available from 2008.
[7] Guidelines on the Recognition of External Credit Assessment Institutions, January 2006.
[8] EU supervisors may choose not to use the CEBS mechanism as the initial stage of ECAI recognition, handling the whole process themselves. ECAI may also approach national supervisors directly, rather than using the CEBS Common Basis Application Pack.
[9] We do not suggest that *Sharī`ah*-compliant financing assets constitute a 'separate asset class', since various asset classes may be comprised within this category of assets , such as sovereign *sukūk*, corporate *sukūk*, "claims on financial institutions", "claims arising from asset-based financial instruments" such as *Murābahah,* or equity rights in partnership entities such as *Mushārakah* or *Muḍārabah*.

the concept of displaced commercial risk (DCR) when dealing with returns on investment accounts that are based on a *Muḍārabah* contract).

12. It should be noted that although an ECAI has demonstrated that it is competent to analyse conventional commercial entities such as banks or corporations, this does not imply that it is thereby necessarily competent to analyse *Sharī`ah*-compliant financial assets.

13. Supervisory authorities are not expected to prescribe the methodology to be used by ECAIs in reaching their ratings.[10] However, in view of the unfamiliarity of many aspects of *Sharī`ah*-compliant financial services, and the speed at which they are changing, supervisory authorities may wish to specify a basic list of areas in which an ECAI should demonstrate analytical awareness when rating *Sharī`ah*-compliant financial assets.

14. The principal areas where *Sharī`ah*-compliant finance may differ from conventional finance include, though are not limited to, the following:

a) different meanings of ratings and the concept of default;
b) priority of claims;
c) corporate governance and the role of the *Sharī`ah* Board;
d) risk mitigation techniques to cater for DCR;
e) definition of capital;
f) trading in *sukūk* does not involve trading in debt (unlike conventional bonds);[11]
g) asset valuations; and
h) loss given default.

15. It should be noted that this list is not exhaustive, and also that this Guidance Note does not include guidance on the relative weights that these factors should be given in reaching conclusions on ratings. Rather, this Guidance Note aims to provide guidance to national supervisors who will be recognising ECAIs whose ratings may be used by IIFS reporting their risk-weighted capital ratios under the CAS. The Guidance Note recognises that national supervisors retain the ultimate authority in determining both recognition criteria and the recognition process, as well as in deciding whether to recognise an ECAI.

16. The IFSB believes that it has a role to play in facilitating the emergence of generally accepted recognition criteria and the related recognition process. The IFSB also hopes that this Guidance Note will serve to promote a wider debate on key points of rating methodology for *Sharī`ah*-compliant instruments.[12]

[10] Prescribing the existence of a rigorous methodology is not the same thing as prescribing what that methodology should contain.

[11] S*ukūk* holders derive their returns either from: (a) an underlying real asset (*Ijārah sukūk*) or pool of assets, or the usufruct of such assets, which is fractionally owned by the *sukūk* holders rather than being collateral for a debt as with conventional asset-backed securities; or (b) a securitised partnership (*Muḍārabah* or *Mushārakah sukūk*) in an underlying business venture.

[12] In developing this Guidance Note, the IFSB has benefited from discussions with a number of rating agencies and market participants during the IFSB Workshops on Ratings Assessment Issues, held in 2003, in Bahrain, and in 2006 and 2008 in Malaysia.

SECTION 2: DEFINING THE "ACCURACY" AND "MEANING" OF RATINGS

2.1 "Accuracy" and "Meaning"

17. ECAIs seeking recognition should outline the intended meanings (that is, correct interpretations) of their ratings, both in terms of the meaning of "default"[13], the probability of default and likely rating transition, and should show that they are building systems that will enable them to compare ratings against actual default and transition outcomes, as such data become available.

18. It is reasonable to suppose that supervisory authorities will expect recognised ECAIs to produce "accurate" ratings, and that, even if rating levels differ between ECAIs (that is, one ECAI may rate an asset as A+, while another may rate the same asset as A–), the ratings themselves may have the same "meaning". Yet, "accuracy" and "meaning" are far from simple concepts in the rating business. "Accurate" in this context means that the prediction in the rating is shown to be consistent with *ex post* observations.

19. Credit ratings are predictions of an issuer's ability to discharge its financial obligations and, as such, represent nothing more than the opinion of the ECAI. A rating contains two predictive elements: (a) a prediction of the relative creditworthiness of one issuer in relation to other issuers (that is, the prediction that assets rated AA will be in default less frequently than assets rated A, which in turn will be in default less frequently than assets rated BBB); and (b) an assessment of the likelihood that this particular asset will be in default during the rating time frame. Some ECAI ratings go beyond a prediction of default to predict expected loss. Both (a) and (b) (and within (b) both default and expected loss) can be tested against the historical record if a sufficiently large pool of data is available.[14]

20. The ability of an ECAI to test the accuracy of its ratings is dependent on its having a large set of data, including not only a large number of rated issuers and financial instruments, but also a reasonable number of rated issuers and financial instruments that have defaulted. This is not a problem in most areas of the financial markets, where such data are abundant. However, in *Sharī`ah*-compliant finance, which is a relatively new form of finance, there are fewer rated issuers and financial instruments and almost no cases of default. Consequently, it is not yet possible to use default data to test the accuracy of ratings of *Sharī`ah*-compliant financial assets. The lack of default data, combined with the small number of rated issuers and issues in *Sharī`ah*-compliant finance, may limit an ECAI's ability to demonstrate statistically the accuracy of its rating predictions.

21. An ECAI should make clear what predicted frequency of default it assigns to a *Sharī`ah*-compliant financial asset when rating it at a certain level, taking into account economic cycles and other factors.

22. ECAIs should also publish data on the transition trends of their own ratings. Rating changes, from one level to another, should generally show consistent and intuitive transitions. Ratings may reasonably be expected to change over time, owing either to factors specific to the *Sharī`ah*-compliant financial asset or to general market conditions. But if the extent and direction of such movements are unpredictable and inconsistent, then the accuracy of the ECAI's ratings may be called into question. For example, if ratings of *Sharī`ah*-compliant financial assets are frequently upgraded or downgraded by several notches in a short space of time, then, whatever the underlying

[13] See paragraphs 25-27 below for a discussion of 'default'.

[14] Expected loss (EL) is defined as PD * LGD where PD is "probability of default" and LGD is "loss given default". Basel II gives reference cumulative default rates (CDR) to which an ECAI's ratings should be aligned for the purposes of determining risk weights. It is important that ECAIs understand the likely loss characteristics of defaulting *Sharī`ah*-compliant financial assets, even if their ratings do not speak to expected loss. That is why LGD is included as one of the issues which recognised ECAI would be expected to address – see paragraph 44.

economic conditions, a possible conclusion is that the ECAI is attempting to correct ratings that it now believes were incorrectly assigned.

2.2 Different "Types" of Rating

23. The meaning of ratings in general, as explained above, needs to be understood in conjunction with the fact that different "types" of rating may exist. For example, in conventional finance, ratings of debt instruments issued or held by banks and ratings of mutual funds are two different types of rating due to the differing contractual obligations involved, albeit both types of rating refer to the ability of the rated entity to discharge its financial obligations and, in that sense, are concerned with the same underlying concept.

24. An institution that issues a bond is contractually required to pay all interest and make all repayments of principal in full and on time. In contrast, a mutual fund into which an investor has placed $100 is not contractually obliged to repay that $100. The fund is contractually obliged to repay whatever the value (that is, net asset value) of the investment has become at the time when redemption is requested. If the fund has fallen by 10%, then it is obliged to repay $90. If it has risen by 10%, then it is obliged to repay $110. In this case, the ratings typically predict the ability of the fund to repay $90, $110 or whatever the value of the investment in the fund is at the time.

25. In Islamic finance, assets or *sukūk* may (a) be such that periodic payments are contractually due (as in the case of *Ijārah* assets or *Ijārah sukūk*) or (b) be based on profit- and loss-sharing (*Mushārakah*) or profit-sharing and loss-bearing (*Muḍārabah*) contracts where the obligation to make a payment and the maintenance of capital are subject to investment performance. In the case of (a), the term "default" is applicable as it is to conventional financial instruments. However, in the case of (b), the nature of the contractual obligations is such that an investor may be concerned not just by default in the sense of a failure to meet these obligations, but also by the risk of capital impairment.

26. For ease of reference, the IFSB has made a distinction between a default in the sense of a failure of an institution (for example, an *Ijārah* fund) to discharge its contractual obligations to an investor and a capital impairment – that is, a failure to repay the capital sum originally invested.[15] In the example quoted above, the failure of a fund to repay either $90 or $110 would be a default, while the failure to repay $100 would be an instance of capital impairment.

27. The example given above also illustrates the types of defaults on *qarḍ* deposits (that is, unremunerated current accounts) and those on profit-sharing investment accounts (PSIA). In the case of *qarḍ* deposits, the IIFS is contractually required to repay 100% of the principal amount on demand; whereas in the case of the PSIA, the amount to be contractually repaid is the current (net asset) value of the investment, which may be more or less than the amount originally invested. Ratings that reflect the risk of a default refer to the risk of a failure to meet a contractual obligation regarding payment. A rating that reflects the risk of a capital impairment on an investment account would, by contrast, not "mean" the same thing, in the sense that it would refer, not to the risk of a failure to meet a contractual obligation, but to the risk of a failure to maintain capital intact in the absence of any contractual obligation to do so. It would therefore be a different type of rating.[16]

[15] While clearly not a default in the legal sense (except in the case of misconduct or negligence), such a capital impairment might be termed a "soft default", as distinct from a default in the legal sense ("hard default"). A "hard default" implies that the institution is in financial distress, which may not be the case for a "soft default".

[16] Various types of ratings are published apart from those that are predictions of default or capital impairment – for example, "stability ratings". Some of the latter are concerned with the variability and sustainability of investment returns, and hence consider the upside as well as the downside aspects of variability. In contrast, a concern with capital impairment focuses on the downside risk.

SECTION 3: CRITERIA FOR RECOGNITION OF ECAIs FOR THE PURPOSE OF CALCULATING THE RISK WEIGHTING OF *SHARĪ`AH*-COMPLIANT FINANCIAL ASSETS

28. There are four types of criteria which this Guidance Note recommends that supervisory authorities use when deciding which ECAIs to recognise:

a) criteria relating to an ECAI's rating process, internal controls and transparency;
b) criteria relating to an ECAI's analytic competence;
c) criteria relating to the accuracy of an ECAI's ratings; and
d) criteria relating to an ECAI's resources and financial condition.

29. Much of the work that has been undertaken by international regulators to define recognition criteria for ratings in the field of conventional finance can be applied when recognising ratings on *Sharī`ah*-compliant financial assets. For example, the need for ECAIs to be independent and transparent is no different when the ratings in question are on *Sharī`ah*-compliant instruments rather than conventional financial instruments. In such situations, there is no need to "re-invent the wheel".

30. While the work done by international regulators in respect of ratings on conventional financial assets is useful as far as it goes, it does not provide robust criteria for recognising an ECAI's competence to rate *Sharī`ah*-compliant financial assets. The key area where the work already done by international regulators needs to be extended is in the field of rating methodology, while the question of rating accuracy also needs to be considered.

31. The recognition criteria outlined in this paper are not intended to be comprehensive, but they do encompass the key elements that, in the opinion of the IFSB, should be included in a recognition process. The criteria below draw heavily on the work already published by CEBS, referred to above.

3.1 Rating Process, Internal Controls and Transparency

32. ECAIs should demonstrate that their rating processes and outcomes are not conditioned by conflicts of interest; or, if a conflict of interest is unavoidable, procedures should be in place to ensure that it does not affect rating decisions.

33. ECAIs should demonstrate that they have an independent process for assigning ratings that precludes the ability of external parties to put pressure on the agency or its staff with a view to influencing rating outcomes.

34. ECAIs should demonstrate that they have a robust and consistent process by which ratings are assigned.

35. ECAIs should make their ratings and their rating methodologies publicly available free of charge. ECAIs should also publicly explain the meaning of their ratings, including the time horizon over which an ECAI deems a rating to be valid.

36. Where sufficient data exist, ECAIs should publish, free of charge, analyses of the accuracy of their ratings and of trends in rating transition.

3.2 Analytic Competence

37. *Sharī`ah*-compliant financial assets should be considered as a distinct set of asset classes since they have credit characteristics which are distinct from those of the other three asset classes identified by CEBS in its January 2006 Guidelines.[17] Just as CEBS proposes that these three asset classes form the basis of the ECAI recognition process, "with separate assessments of an ECAI's methodology by competent authorities in each of the broad asset classes", so supervisory authorities should conduct a separate assessment of an ECAI's methodology for *Sharī`ah*-compliant financial assets.

38. Even though, in principle, supervisory authorities are recognising an ECAI simply on its ability to rate accurately specific *Sharī`ah*-compliant financial assets to which IIFS are exposed, ECAIs seeking recognition should demonstrate a comprehensive understanding of the broader analytical and risk issues within *Sharī`ah*-compliant finance, as indicated in the next paragraph, as well as an appreciation of the specific features of rated *Sharī`ah*-compliant assets.

39. ECAIs seeking recognition should publish a ratings methodology to underpin their analysis of *Sharī`ah*-compliant financial assets. This methodology should demonstrate that the ECAI understands not only the ways in which some general principles underlying *Sharī`ah*-compliant finance differ from general principles underlying conventional finance, but also the particular features of *Sharī`ah*-compliant financial instruments that may cause their risk characteristics to differ from conventional financial instruments that may appear similar, or even share some similar characteristics (for example, some *Sharī`ah*-compliant financial instruments typically involve exposures to price risk as well as credit risk, while others involve exposures to risk of capital impairment as distinct from default risk).

40. The list of issues to be considered by ECAIs is not intended to be exhaustive, but ECAIs should, at a minimum, demonstrate a clear understanding of these issues. The IFSB does not intend to recommend a particular methodological approach that ECAIs seeking recognition should take.

41. The issues identified below reflect the state of the *Sharī`ah*-compliant market today, and the IFSB recognises that the market is developing rapidly. Going forward, the IFSB will review the issues identified below and consider whether they need to be changed, or new issues added, in order to ensure that they continue to reflect key analytic areas within *Sharī`ah*-compliant finance.

42. To demonstrate their understanding of the general principles underlying *Sharī`ah*-compliant finance, ECAIs should be asked to include comments on the following issues in their methodologies:

How will the ECAI distinguish between ratings that have different meanings, and in particular between "default" and "capital impairment"?

43. As a result of the different natures of default considered above, the meaning of ratings may differ depending on the type of instrument being rated. For example, suppose that a default on a *qard* deposit is a failure to repay 100% on demand, while a default on an unrestricted PSIA is a failure to repay its net asset value at the time repayment is requested. How will the ECAI make clear that in the case of a *qarḍ* deposit, the rating refers to the probability that depositors will receive 100% of their deposit; while in the case of an unrestricted PSIA, the rating refers to the

[17] As mentioned in paragraph 9 above, these three asset classes are structured finance, public finance and commercial entities.

probability that the investor will receive the net asset value, whatever that may be at the time.[18] One option here is for the ECAI to publish different ratings predicting defaults and/or capital impairments, but it is important that investors are able to distinguish one from the other.

44. In addition, where applicable, ECAIs should make clear whether their ratings are predictions of default (PD) or of expected loss (EL).

To what extent does the ECAI think that the priority of claim may differ when a creditor is holding a* Sharī`ah*-compliant asset, as opposed to a conventional asset?

45. In conventional finance, priority of claim is defined in the loan documentation and by local laws; however, within *Sharī`ah*-compliant finance, additional factors may come into play, such as *Sharī`ah* requirements for equitable treatment of creditors.[19] This might also affect the loss given default.

Does the ECAI believe that the over-riding obligation for financial operations to conform to the* Sharī`ah *could affect the governance of financial institutions and issuers of financial instruments, with the result that such institutions and instruments may display differing credit characteristics from similar conventional instruments?

46. Governance standards applicable to IIFS are set out in the IFSB's *Guiding Principles on Corporate Governance for IIFS*. These principles include all those that are applicable to conventional banks, as well as principles related to compliance with *Sharī`ah* rules and principles. This may have implications for credit characteristics, especially as issues of reputational risk assume greater importance for *Sharī`ah*-compliant issuers of financial instruments than for conventional issuers.

47. To demonstrate their understanding of the credit characteristics of specific financial assets, ECAIs should be asked to include comments on the following issues in their methodologies:

How will the ECAI's analysis incorporate the issue of DCR?

48. An IIFS may be under market pressure to pay a profit rate that exceeds the rate of return it has earned on the assets financed by a *Muḍārabah* contract investor. In order to do this, the IIFS may waive its rights to its *Muḍārib*'s share of the profits so as to satisfy and retain its fund providers, even if it is not contractually obliged to do so. DCR derives from competitive pressures on the IIFS to attract and retain investors.

49. An IIFS's profits (and hence financial strength) may thus be reduced by the need to forgo its *Muḍārib*'s share. IIFS may respond to this pressure by creating two types of reserves: a profit equalisation reserve (PER), which is a reserve appropriated out of gross income, before allocating the *Muḍārib*'s share; and an investment risk reserve (IRR), which consists of amounts appropriated out of the income of the investment account holders (IAH) only, after the deduction of the *Muḍārib*'s share. The existence, or non-existence, of such reserves could have a significant impact on the creditworthiness of IIFS, and ECAIs should explain in their methodologies how these issues are factored into their ratings.

When rating IIFS, how will the ECAI define "capital"?

[18] As implied in paragraphs 25 and 26 above, ECAIs could have two types of ratings on an unrestricted investment account: one predicting the ability to repay net asset value, and another predicting the ability to repay the capital invested.

[19] Provided none of the creditors has been given collateral, in which case the creditor with collateral has priority over other creditors to the extent of that collateral.

50. Capital is used by IIFS to protect the depositors and some classes of investor from losses. ECAIs should make clear what constitutes capital in an IIFS, and therefore the extent to which depositors and certain classes of investors are protected against losses. For example, an IIFS's own capital may be maintained against only a portion of assets attributable to unrestricted IAH, since the credit and market risks arising from such assets may be borne wholly or partly by the unrestricted IAH, while poor performance of such investment accounts may be smoothed by taking funds from the portion of the PER that is attributable to unrestricted IAH. The other part of the PER, which is attributable to the shareholders, is entered into Tier 1 capital. A corollary to such an attempt to define "capital" is a consideration of the types of losses that an IIFS's capital may be required to absorb.

When rating* sukūk*, under what circumstances would the ECAI assign a rating that is higher than that assigned to the assets underlying the* sukūk *issuance?

51. *Sukūk* represent fractional rights of ownership of either (a) a given asset or pool of assets (or of the usufruct of such assets) or (b) a partnership in a business venture (see note 11 to paragraph 14.f above). In the case of (a), if the assets are considered to be of a higher credit quality than those of the originator of the *sukūk*, and *sukūk* holders have effective recourse to those assets in the case of default, the then the rating of the *sukūk* could be higher than that of the originator. Alternatively, if those assets are considered to be of a lower credit quality than those of the originator of the *sukūk*, then (in the absence of recourse to the originator) the rating of the *sukūk* could be lower than that of the originator. Both of these examples assume that there is no "credit substitution", such as *Sharī`ah*-compliant credit enhancement from the issuer.

How does the ECAI incorporate market risk and operational risk, as well as credit risk exposures, into instruments that originate as credit exposures, and into lease-based financings, and deal with the credit risk on financings that are profit and loss sharing or profit sharing and loss bearing?

52. *Sharī`ah*-compliant financial contracts such as *Murābahah* require an IIFS to have ownership of assets (inventory) as part of asset-based financing activities on its balance sheet for a short period of time pending resale – something that would not normally be seen in conventional banks. Such assets may be subject to substantial market risks if the contract is non-binding in nature. As a result, the risks associated with these assets are not confined to credit risk. Similar considerations apply to *Ijārah* (leased) assets that may be held by an IIFS prior to being transferred to the lessee. However, in the case of operating *Ijārah*, while the credit risk is mitigated by the lessor's right to repossess the assets in the event of default by the lessee, the lessor is also exposed to the risk arising from the obligation to ensure that the lessee's right to the services of the asset is not impaired or to provide a substitute asset if necessary to honour that obligation in *Ijārah* according to certain specifications. Other instruments used by IIFS for financing working capital or projects, such as *Salam* and *Istisnā`*, also have particular risk characteristics that need to be understood.

53. Financings made via *Muḍārabah* and *Mushārakah* contracts may contribute substantially to an IIFS's earnings, as well as entailing significant market, liquidity, credit and other risks, potentially giving rise to earnings volatility and losses. The capital invested may be used to purchase shares in a publicly traded company or privately held equity, or be invested in a specific project, portfolio or pooled investment vehicle. In the case of a specific project, IIFS may finance at different stages of the project.

54. As *Muḍārabah* and *Mushārakah* are used for profit-sharing financings, the capital invested by the fund provider does not constitute a right either to a fixed return or to the repayment of the capital invested, but is explicitly exposed to impairment in the event of losses (capital impairment risk). Valuation and accounting play an important role in measuring the quality of an equity

investment, especially in a privately held entity, for which independent price quotations are either unavailable or insufficient in volume to provide a basis for meaningful liquidity or market valuation. An appropriate and agreed method to be applied to determine the profit of the financing can take the form of a certain percentage of either gross or net profit earned by the *Muḍārabah* or *Mushārakah* business, or any other mutually agreed terms. In the case of a change in the partnership shares in a *Mushārakah* (for example, in a Diminishing *Mushārakah*), the shares changing hands might be valued either at fair value or on some other mutually agreed basis in transaction.[20] *Muḍārabah* and *Mushārakah* may also be used by IIFS for purposes other than financing, such as joint ventures or partnerships for trading, in which case market risk may be applicable.

Does the ECAI believe that the asset-based nature of many* Sharī`ah*-compliant financial instruments is likely to result in higher recovery rates (lower "loss given default") than would be seen in comparable conventional financial instruments?

55. Since many *Sharī`ah*-compliant instruments give investors a direct claim on an asset (as opposed to a general claim on an institution that has numerous other obligations), it may be argued that such investors are in a stronger position to attach assets in the event that the issuer defaults than they would be if they were holding conventional instruments. In fact, this may or may not be the case, depending on the applicable legal system. The ECAI should provide its opinion on likely recovery trends, across a variety of *Sharī`ah*-compliant instruments, while also stating whether its ratings incorporate loss given default, or only default risk. The IFSB recognises that statistics on loss rates of defaulted *Sharī`ah*-compliant instruments are at a very early stage of compilation.

3.3 Accuracy of Ratings

56. Supervisory authorities may reasonably expect ECAIs to produce accurate ratings. The question of what constitutes an "accurate" rating was addressed in Section 2.1 above.

57. While the task of demonstrating accuracy may be straightforward where historical data on defaults and rating transitions are abundant, it is a far more difficult task where they are not. Lack of default data on *Sharī`ah*-compliant financial assets, combined with the small number of ratings outstanding, will mean that no rating agency is able to demonstrate statistically the accuracy of its rating predictions on *Sharī`ah*-compliant financial assets.

58. An ECAI seeking recognition should outline the intended meaning of its ratings, both in terms of default probability and likely rating transition, and show that it is building systems that will enable it to compare ratings against actual default outcomes as and when such data become available.

59. An ECAI seeking recognition should also make clear what predicted frequency of default it assigns to a *Sharī`ah*-compliant financial asset when rating it at a certain level, taking into account economic cycles and other factors. For example, an ECAI might say that its ratings are intended to map to the default frequencies cited in Basel II.[21]

60. ECAIs should also publish data on the transition trends of their own ratings. Rating changes, from one level to another, should generally show consistent and intuitive transitions.

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[20] The returns of IAH may also be smoothed from the part of PER attributable to shareholders if the part of PER attributable to IAH is not adequate, and vice versa.

[21] These default frequencies appear in Appendix 2 of the June 2006 Comprehensive Version.

61. The IFSB recognises that new and/or small rating agencies may not have strong track records with which to demonstrate their analytic competence. In such circumstances, national regulators should take account of stated performance objectives and an agency's commitment to disclose its performance track record when it becomes measurable. It is to be emphasised that this Guidance Note in no way wishes to hinder the development of new and/or small rating agencies.

3.4 Resources and Financial Condition

62. ECAIs should demonstrate that they have sufficient resources to conduct high-quality analysis, both when assigning ratings for the first time and when maintaining ratings after they have been assigned. ECAIs should demonstrate that their analysts have expertise that is relevant to the sectors covered by the agency.

63. ECAIs should demonstrate that they have information technology systems capable of collecting and analysing data related to the accuracy of ratings. Such data would include, for example, statistics on default frequency and rating transitions.

64. ECAIs should demonstrate that they have the financial resources to remain in business over the time horizon of their ratings.

DEFINITIONS

The following definitions are intended to help readers to have a general understanding of the terms used in the Guidance Note and related documents. They are by no means an exhaustive list.

Diminishing *Mushārakah*	Diminishing *Mushārakah* is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Ijārah	An *Ijārah* contract refers to an agreement made by IIFS to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An *Ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *Ijārah* contract.
Investment risk reserve (IRR)	Investment risk reserve (IRR) is the amount appropriated by the IIFS out of the income of IAH, after allocating the *Mudārib*'s share, in order to cushion against future investment losses for IAH.
Istisnā`	An *Istisnā`* contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
Muḍārabah	A *Muḍārabah* is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the *Muḍārib* (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the *Muḍārabah* agreement, while losses are to be borne solely by the capital provider unless the losses are due to the *Muḍārib*'s misconduct, negligence or breach of contracted terms.
Murābahah	A *Murābahah* contract refers to a sale contract whereby the IIFS sell to a customer, at an agreed profit margin plus cost (selling price), a specified kind of asset that is already in their possession.
Mushārakah	A *Mushārakah* is a contract between the IIFS and a customer whereby the both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of *Mushārakah* agreement, while losses are shared in proportion to each partner's share of capital.
Profit equalisation reserve	Profit equalisation reserve (PER) is the amount appropriated by the IIFS out of the *Muḍārabah* income, before allocating the *Muḍārib*'s share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
Qarḍ deposits	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period.

Salam	A *Salam* contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The IIFS as the buyers make full payment of the purchase price upon execution of a *Salam* contract. The commodity may or may not be traded over the counter or on an exchange.
Sukūk	*Sukūk* are certificates with each *Sakk* representing a proportional undivided ownership right in tangible assets, or a pool of assets, or in the assets of a specific project or investment activity.
Unrestricted Investment Accounts	The account holders authorise the IIFS to invest their funds based on *Muḍārabah* or *Wakālah* (agency) contracts without placing any restrictions on them. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.