Islamic Banks’ Risks: It’s Rating Methodology and Shariah Assessment Solutions

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Abstract

The remarkable worldwide development of the Islamic finance industry and Islamic capital market has resulted in industry players demanding that Islamic banks be rated. Ratings will help them to assess whether a firm is utilizing the funds entrusted to it with due care, by providing indications of good performance so that informed decisions can be made. Since Islamic finance is recognized as being fundamentally different from conventional finance, a rating methodology is needed; one that can capture the unique dimensions of Islamic banks, in particular Shariah (Islamic law) risk. Therefore, this study will examine to what extent credit rating agencies, in particular standard and poor’s, Fitch and Moody’s differ in evaluating the creditworthiness of conventional and Islamic banks. Owing to Islamic banks’ operations needing to comply with Shariah law, this study will further investigate the way to assess Shariah compliance from the perspective of Shariah scholars and practitioners. The research on ratings not only helps boost investor confidence in the Islamic finance industry, but also leads to a better understanding of the concept. This is despite the different methods adopted by the agencies concerned.

Keywords: rating methodology, Shariah, Islamic banks, conventional banks

1. Introduction

Islamic banks are becoming increasingly important worldwide, and now operate in the same places that conventional banks do. Similar to conventional banks, Islamic banks do all those functions expected of a financial institution and assist the business world by providing services required to run an economy smoothly. However, the philosophy and operational methods of Islamic and conventional banks are different. From a risk perspective, this difference in philosophies resulted in Islamic banks being confronted with risks that are akin to those encountered by conventional financial institutions and risks that exclusively stem from Shariah implications. Taking into account the ‘unique’ risks embedded in Islamic bank operations, the rating methodology use by standard and poor’s, Fitch and Moody’s in determining the credit strength of conventional banks will be examined. Additionally, to what extent credit rating agencies differ in evaluating conventional and Islamic banks will be investigated. How to assess Shariah compliance from the perspective of Shariah scholars and practitioners will also be considered.

In examining why rating methodology for Islamic banks has taken this particular course, the following sections will, in order, discuss a literature review pertaining to Islamic banks and their operations, followed by an outline of the methodology employed in this study. The different rating methodologies used by various international credit rating agencies for determining the credit strength of conventional banks and Islamic banks are considered, including the assessment of Shariah compliance from the perspective of Shariah scholars and practitioners.

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2. Literature review

Over the past few decades the Islamic finance industry has rapidly expanded worldwide. While it is difficult to identify precisely when the first formal Islamic financial institution began its operations, references are often made to the Mitghamr Egypt Savings Association in 1963. Today the Islamic banking industry has an average growth rate of 15% - 20% annually and Shariah-compliant financial assets are estimated at roughly US$2 trillion, covering bank and non-bank financial institutions, capital markets, money markets and takaful (insurance) (The World Bank, 2015). While the rapid expansion of Islamic financing activity has created expectations, it has also raised apprehensions about the risks that may be associated with it. As such, the premise of Islamic banks’ risks as opposed to conventional risks has been widely discussed in the Islamic finance literature. The philosophy and operations of Islamic financial institutions has been explained by Ahmed (2011), Hassan and Mahlknecht (2011), Hassan and Lewis (2007), El-Gamal (2000) among others. While other studies such as Hanif (2011) and Beck, Demirgüç-Kunt, and Mervouche (2013) have discussed in detail the different philosophies and operations of Islamic banks as opposed to conventional banks, some analyses have focused on risks in Islamic banking system operations (see How, Karim, & Verhoeven, 2005; Said, 2013). Hence, this study believes that the risks of the Islamic banking system should be extended to how all those risks are evaluated by credit rating agencies, given that ratings will help eliminate gharar (uncertainty) from transactions. Hence, investors or shareholders will be more aware about their investment risk (Faheem, 2000).

Since Islamic banks’ risks constitute a serious concern and similar to what conventional banks encounter across the globe, the financial strength of Islamic banks will not uniform. In this regard, a number of reasons prompt financial institutions to obtain a credit rating from the leading credit rating agencies. This motive includes the ability to utilize the inter-bank deposit market in order to widen funding sources. However, the ability to obtain these deposits depends on having credit ratings as required by the credit policies of banks that have surplus deposits seeking to deploy them in the inter-bank deposit market. Furthermore, the ceiling of the level of these deposits depends on the credit rating of financial institutions whereby a higher ceiling is assigned to progressively higher credit rating and vice versa. Therefore, financial institutions that lack a credit rating cannot utilize the inter-bank deposit market (Leng & Orthman, 2014, pp.251-252). Given the importance of the credit rating, previous studies indicate that credit rating agencies appear to disagree more in the measurement of credit risks for banks than in their credit risk measurement for other industries. Following Cantor and Parker (1994), Morgan (2002), and Packer and Tarashe (2011) the difficulties rating agencies have in forecasting banks’ performance and assigning a rating are rooted in the unique features of the banking industry. This distinction is characterized primarily by banks’ and other financial institutions’ regulatory and legal status. They are usually licensed to take deposits from the general public, provide credit, are subject to prudential regulation and have access to central bank liquidity. In recent decades, structural changes in the banking sector have also increased opacity – thus rendering the assessment of bank creditworthiness even more complicated. Financial innovation has made banking a much more complex industry; more direct funding from financial markets and securitization activity have helped forge innovations that have intensified credit risk transfer between intermediaries (Boot & Thakor, 2010).

Costly observability of creditworthiness reduces the ability of market participants to screen noisy ratings and increases the cost to a rating agency of issuing informative forecasts (Bar-Isaac & Shapiro, 2011). Generally, credit rating agencies may find it more profitable simply to issue lower-quality ratings rather than to confront increasing bank complexity (Mathis, McAndrews, & Rochet, 2009). The complexities in determining bank assessment lead some studies to examine rating quality and performance of conventional banks. Hau, Langfield and Marques-Ibanez (2012) examine the quality of credit ratings assigned to banks in Europe and the United States by the three largest rating agencies. Subsequently the results suggest that rating agencies assign more positive ratings to large banks. A study by Rojas-Suarez (2001) investigates the value of bank credit ratings in emerging markets and concludes some rating agencies rely more on macroeconomic variables than on bank-specific financial ratios. Considering the difficulties in assessing conventional banks’ performance, it can be argued that it is more relevant for Islamic banks since their operations must comply with Shariah. This premise raises a question of how credit rating agencies assess Shariah risk when making opinions regarding the individual Islamic bank’s overall creditworthiness and the capacity of the Islamic bank to satisfy its financial obligations.
3. Methodology

This study employs qualitative research methods through documentary review to elicit relevant information regarding credit rating methodology of Islamic and conventional banks from six credit rating agencies. Specifically, these agencies are Standard & Poor’s, Moody’s, Fitch, Islamic International Rating Agency, Rating Agency Malaysia and Malaysia Rating Corporation Berhad. Additionally, formal publications derived from the Accounting Auditing Organization for Islamic Financial Institutions (AAOIFI), and Islamic Capital Market, of the Securities Commission Malaysia and various Islamic banks’ reports were also considered.

4. How different are Islamic banks’ risks from conventional banks?

Since this paper focuses on to Islamic banks’ risks, it serves as a starting point for understanding the dynamics of the different risks inherent in conventional and Islamic banks. Generally, the main difference between Islamic banks and conventional ones is the sources of law which govern them and ultimately leads to a significant difference in how Islamic banks operate compared to conventional institutions. While the Islamic banking system is based on the Islamic faith and must stay within the limits of Islamic law or Shari’ah in all of its actions and deeds, the functions and operating modes of conventional banks are based on fully man-made principles. As far as Shari’ah is concerned, the general principles governing the operations of Islamic banks can be summarized as follows: (i) prohibitions on interest-based (riba) transactions, (ii) no uncertainty (gharar) or speculation, (iii) the exclusion of financing and dealing in sinful and socially irresponsible activities (e.g. weapons, pork, gambling), (iv) adherence to profit risk-sharing, and (v) financial transactions must be backed by tangible assets. Since Shari’ah-compliant finance relies on the idea of profit and loss and thus risk-sharing, on both the liability and asset side, this would suggest clear differences in funding and activity structures of Islamic and conventional banks (Ariff, 1988). Hence, originating from the stylized balance sheet of conventional and Islamic banks (as shown in Figure 1), components of assets and liabilities reveal the extent of the different types of risk to which a bank exposed.

Figure 1: Overview of different types of conventional and Islamic banks’ operation and risks
On the liability side of conventional banks, they accept savings deposits, issue term certificates such as certificate of deposits (CD), and have capital. For these sources of funds, depositors will transfer any risk to the conventional banks, which guarantee a pre-specified return. On the asset side, there is much more diversity and options in the form of marketable securities, trading accounts, lending to corporations and to consumers. Borrowers are required to pay interest independent of the return on their project. Conventional banks transfer the risk through securitization or credit default swaps (Greuning & Iqbal, 2008). Consequently, financing provided by conventional banks is deemed to be debt-based. In this regard, conventional banking was built on the fundamentals of the debtor-creditor relationship with interest being the price of credit and reflecting the opportunity cost of money. Hence, money is considered to be a commodity.

Following conventional banking operations, risks that are common to them are often cited as credit risks, liquidity risks, market risks and operational risks (Asian Institute of Finance, 2013; Bessis, 2011). Since conventional banks’ core operation is to accept deposits and to provide loans to various entities, several types of loans are usually the largest part of bank assets. Being so, this is the reason why credit risk is the oldest, the most important and primary risk in banking (Vodová, 2003). Conventional banks make their profits from the margin between the borrowing and lending rates of interest, yet these activities will expose conventional banks to the danger of asset-liability mismatch and maturity mismatch (Greuning & Iqbal, 2009).

Following Bureau (2010), the most serious consequences of asset-liability mismatch are interest rate risk and liquidity risk. Furthermore, certain funding instruments also expose a bank to several potential dangers such as benchmark rates, foreign exchange rates and equity prices on the economic value of an asset or any losses arising from adverse movements in market prices which can be grouped into market risks (Aaron, Armstrong, & Zelmer, 2012). Importantly, beyond the risks contained in the bank’s principal activities, i.e. those involving their own balance sheet and basic business of lending and borrowing, conventional banks are also exposed to operational risks – the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (BCBS, 2001).

4.1 Risks specific to Islamic banking

For Islamic banks, on the liability side saving and investment deposits take the form of profit-sharing investment accounts. Demand deposits or checking/current accounts in Islamic banks assume the nature of qard hasan (interest-free loans) that are returned fully on demand (Ahmed & Khan, 2007). In this context, sources of funds for Islamic banks promote risk-sharing between the provider of capital (investor) and the user of funds (entrepreneur). On the other hand, for the asset side, banks use murabahah (cost-plus or mark-up sale), instalment sale (medium/long-term murabaha), bai-muajjal (price-deferred sale), istisnaa/salam (object deferred sale or pre-paid sale) and ijara (leasing) and profit-sharing modes of financing (musharakah and mudarabah) (Ahmed & Khan, 2007). These instruments on the asset side as a uses of funds, enable Islamic banks to employ the profit-sharing principle to reward depositors. Theoretically, it has been an ambition of Islamic economists that on the liability side, Islamic banks should only have investment deposits. On the asset side, these funds will be channeled through a profit-sharing contract. Under such a system, any shock on the asset side shall be absorbed by the risk-sharing nature of the investment deposit.

3 Interest rate risk arises because deposits are of shorter maturity and they are repriced faster than loans. Every time a deposit matures and is rebooked, if the interest rates have moved up the bank will have to pay a higher rate on them. However, the loans cannot be repriced that easily. Because of this faster adjustment of deposits to interest rates the asset-liability mismatch affects net interest margin or the spread banks earn. In this context, changes in interest rates also affect the underlying value of the bank’s assets, liabilities and off-balance sheet instruments because the present value of future cash flows (and in some cases, the cash flows themselves) change when interest rates change.

4 Liquidity issues also arise when loans and deposits have different maturities. Depositors have to be repaid when their funds mature but banks cannot recall their loans. They will have to find new deposits or roll over those that are maturing or else they will not be able to service their depositors. In an acute situation they may have to pay very high interest in order to raise funds.
In this regard, Islamic banking will have extra protection, for instance in the form of mudharabah's saving and investment (S & I) deposits. It is based on the profit and loss sharing contract between Islamic banks and their account holders. Because of this quasi equity, a priori, Islamic banking is expected to take less risks in comparison to their conventional counterparts. These banking institutions thus have less incentive for risk shifting in times of distress. In this way, Islamic banking offers a more stable alternative to traditional banking.

A closer look at the sources and uses of funds of conventional and Islamic banks, shows that from the risk point of view, Islamic banks face two types of risk. One is akin to those confronted by conventional financial institutions and the second is exclusive to Islamic banks due to their Shariah implications (Ahmed & Khan, 2007; Dar & Azeem, 2013). This means that all common risks faced by conventional banks are also relevant to Islamic banks. However, referring to Shariah considerations (Ahmed & Khan, 2007), including specific contractual features in Islamic finance, the challenges of Islamic banking operations are more significant than those faced by conventional banks (Greuning & Iqbal, 2008; Iqbal & Mirakhor, 2007). As noted earlier, one of the prominent features of Islamic finance is that it conforms to Shariah law. Islamic banks have to ensure at all times, that activities and products are consistent with Shariah principles. Failure to comply with such principles will result in the transaction being cancelled and this can lead to fiduciary risk (Ahmed & Khan, 2007). Fiduciary risk is the risk that arises from Islamic banks' failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities (IFSB, 2005). A failure to maintain fiduciary responsibilities will result in a deterioration of Islamic banks’ accountability (Hamidi, 2006). Damage to reputation could eventually cause a withdrawal of funds which would result in a liquidity crisis. It could also encourage customers to stop requesting finance from Islamic banks, triggering a downturn in profitability.

As far as Shariah is concerned, interest in all forms is prohibited. The absence of interest-based (riba) transactions has caused far more serious liquidity risk to Islamic banks compared to their conventional counterparts for a number of reasons. First, there is a fiqh (human understanding of the Shariah) restriction on the securitization of the existing assets of Islamic banks, which are predominantly debt in nature. Second, due to the slow development of financial instruments, Islamic banks are unable to raise funds quickly from the markets. This problem becomes more serious because accessibility of the Shariah-compatible money market and intra-bank market is limited. Third, the lender of last resort (LLR) provides emergency liquidity facility to banks whenever needed. The existing LLR facilities are based on interest and therefore Islamic banks cannot benefit from these transactions (Ahmed & Khan, 2007, p.145). With this in mind, Islamic banks may encounter a more critical and wider mismatch between their assets and liabilities given that liquidity risk arises from either obtaining cash at a reasonable cost from borrowings (funding liquidity risk) or sale of assets (asset liquidity risk).

The unique features of the Islamic financial contracts also resulted in Islamic banks experiencing more significant operational risk compared to conventional banks. Shariah-compliant finance relies on the idea of profit and loss and thus risk-sharing, and these Islamic partnership contracts are best represented by the musharakah (joint venture or partnership financing) and mudharabah contracts. Under musharakah contract for instance, the bank's profit on the loan is equal to a certain percentage of the partner’s profits. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded. Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing the lender to monopolize the economy (Febianto, 2012). These equity-based products are unique to Islamic banking and to some extent, account for its superiority over conventional banking on the grounds of ethics and efficiency. However, there is a strong probability of arising equity investment risk in Islamic banking on the asset side. This equity investment risk emerges from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk (IFSB, 2005). In this respect, the risk may result from the quality of the partner, underlying business activities and ongoing operational matters.

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5 Mudharabah is a partnership in which one party invests its capital (rab-ul-mal) and the other party utilizes its skills and services in the business. The profit is distributed between parties according to a pre-agreed ratio. All the financial loss is borne by the investors. The loss of mudarib is in kind of the sacrifice of time and effort.
Additionally, Islamic banks are also exposed to displaced commercial risk. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has identified displaced commercial risk as the risk occurring when an Islamic bank is under pressure to pay its investors-depositors a rate of return higher than what should be payable under the “actual” terms of the investment contract. This is the transfer of the risk associated with deposits to equity holders. This can happen when a bank underperforms during a certain period and is unable to generate adequate profits for distribution to the account holders (AAOIFI, 1999). This risk implies that the bank may operate in full compliance with Shariah requirements, yet may not be able to pay competitive rates of return as compared to other Islamic banks and competitors. The bank foregoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.

In summary, Islamic banks face additional risks due to the nature of their balance sheet and Shariah compliance requirements. Furthermore, restricted of Shariah compatible short-term securities in most Islamic jurisdictions to hedge against foreign exchange risk or in case of liquidity risk management result challenges in managing market risks. The different risks inherent in conventional and Islamic banks operations leads to a critical question of ‘how do credit rating agencies assess the credit strength of conventional and Islamic banks?’ Further, ‘to what extent do they differ in evaluating conventional and Islamic banks?’

5. Rating approach for conventional banks: What do credit rating agencies consider?

Before examining in detail the rating methodologies for conventional banks, it is important to comprehend the types of credit rating in measuring banks’ performance. In general, there are two types of credit rating assigned by credit rating agencies: (i) issuer credit ratings, and (ii) issue-specific credit ratings. In the case of issuer credit ratings, the rating is an opinion on the obligor's overall capacity to meet its financial obligations. Obligors include entities such as corporations, financial institutions, insurance companies, or municipalities that have been rated by a credit rating agency. Meanwhile, the issue-specific credit rating refers to the current opinion of the creditworthiness of an obligor with respect to a specific debt instrument or a specific financial obligation. The issue-specific credit ratings apply to debt instruments such as commercial papers, certificates of deposits and bonds.

As financial intermediaries, banks are unique in that they are perceived to benefit implicitly or explicitly from sovereign support, even though the government may not control or own any shares in the bank. They often benefit not just from the support given by the parent institution – as any other firm would – but also from that of public authorities, in different forms such as capital injections, asset purchases or liquidity provisions. When there is a commitment to support the creditworthiness of a bank, the rating agency has to evaluate both – the ability and enthusiasm of the parent or sovereign to honor the commitment. In this context, a rating should not be derived in isolation but utilize a holistic approach to assessing bank risk. Hence, creditors need to assess the likelihood and extent of extraordinary support for banks, in addition to assessing the intrinsic financial strength of these institutions. Since a bank’s rating should reflect the industrial, financial and economic context of its business, credit rating agencies generally assign at least two different ratings to banks, specifically “stand-alone” and “all-in” ratings as summarized in Table 1. A stand-alone rating reflects the intrinsic financial strength of the institution relative to its peers and therefore its likelihood of default, assuming that no external support is forthcoming. An all-in rating factor reflects the likelihood and magnitude of extraordinary external support that the bank may receive if and when it is in distress, which is also assessed by credit rating agencies. Consequently, stand-alone ratings provide useful information to a prudential authority interested in the underlying strength of institutions, whereas all-in ratings matter to banks’ creditors and trading counterparties.

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6 This criteria report applies to banks, including commercial and policy banks, and bank holding companies or institutions that are “bank-like”; i.e., they have leveraged balance sheets and engage in borrowing and lending as their core business activities.
Table 1: Rating methodology approaches for conventional banks and Islamic banks

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<tr>
<th>Credit rating agencies</th>
<th>Standalone credit profile</th>
<th>External support</th>
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<td>Standard &amp; Poor’s</td>
<td>Banking Industry Country Risk Assessment (BICRA) methodology:</td>
<td>Extraordinary support</td>
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<td></td>
<td>- macro factors</td>
<td>- by government or group</td>
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<td>- bank-specific factors</td>
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<td>Moody’s</td>
<td>Baseline Credit Assessment (BCA) assessment on standalone financial strength:</td>
<td>Support and structural analysis</td>
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<td>- macro profile</td>
<td>a. affiliate support</td>
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<td>- financial profile</td>
<td>b. loss given failure</td>
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<td>- qualitative adjustments</td>
<td>c. government support</td>
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<td>Fitch</td>
<td>Viability rating:</td>
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<td>- Operating environment</td>
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<td>- Company profile</td>
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<td>- Management and strategy</td>
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<td>- Financial profile</td>
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Source: adapted from Standard & Poor’s (2011), Moody’s (2015) and Fitch (2011)

In assessing banks’ creditworthiness, generally credit rating agencies have set up their own analytical frameworks. Regardless of any “name” designated to the analytical framework by Standard & Poor’s, Moody’s and Fitch, their stand-alone analysis incorporates both quantitative and qualitative analysis and retains classics drivers banks’ credit risks. A quantitative analysis draws on ratios chosen for their predictive capacity, which credit rating agencies assess in the context of the macro-economic and financial environment in which each bank operates, while drawing on a broader set of indicators of risks and their mitigants. Basically, the elements of CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) are inherent in their judgement when rating the credit risk of banks. For the criteria that are beyond those considered in the financial profile, qualitative analysis play a crucial role in their rating methodology. In general, qualitative assessment covers the following areas: business model, management strategies and corporate policies, and business diversification coupled with the management’s track record in handling crises or systemic events. In summary, this setting helps credit rating agencies form a set of analytical judgments coupled with comparison to peer groups. This analysis will drive the stand-alone credit assessment that they assign to each bank.

Further, all-in rating analysis is conducted in two ways: the first is support from a bank’s affiliates and the second is the support proceeding from public entities. The support framework considers both the relationship between a bank and government or its parent group/affiliate and how this relationship alters a bank’s overall creditworthiness and reduces its probability of default. In assessing government support, credit rating agencies generally focus on direct benefaction to an individual bank in providing liquidity or capital injections, or by buying or insuring risky assets. Also examined in the meantime is the extent to which government interference via ownership or regulation influences a bank’s business decisions. At this stage, the credit rating agencies have different rating criteria and methodologies when the bank is a government-related entity or private sector commercial institution. Since a government-related entity plays a concrete role in public policy or the government has a strategic long-term ownership in a bank’s capital, the rating procedure used is very similar to the one employed for sovereign rating assessment. For private sector commercial banks, credit rating agencies factor two important criteria in their rating. The first is an assessment of the banks’ ‘systemic importance’, i.e. the degree to which banks’ failure impacts on all or parts of the financial system and economy where they operate, including the government’s tendency (and capacity), based on past behavior to support private sector commercial banks.
Further, in the second analysis that includes support from entities, generally credit rating agencies focus on three main issues. The first is the relationship between the bank and its affiliates, which basically entails the following: the control relationship between them, the possible supports by regulations, and the strategic fit between the companies and their possible financial links. Second, the stand-alone capacity of the affiliates has to be considered. This aspect is the most restrictive one and could have even negative implications if the affiliate is suspected of needing assistance. The third is studying the possible correlation between their risks with a consideration of their respective operating environments. Building on the stand-alone credit assessment that is computed combining the macroenvironment and financial profiles and adjustments according to qualitative aspects, the bank credit profile is then adjusted with the information about possible support (provided by affiliates and government). In general, there is no predetermined formula which specifies the relevant variables as well as weights attached to each one in arriving at a final rating. Although rating methods may differ from one agency to another, there is a common focus on credit risk assessment.

5.1 Rating approach of conventional versus Islamic banks: to what extent do they differ?

As noted earlier, Islamic financial intermediation is basically different from the prevailing practices of conventional financial institutions. Islamic bank operations, assets and liabilities have special characteristics and risks not found in conventional banks. Owing to their compliance with the Shariah, the operational risks are likely to be more significant for Islamic banks due to their specific contractual features and the limitation of the risk mitigation instruments as compared to their conventional counterparts. Islamic banks, in this sense, are exposed to a range of operational risks that could materially affect their operations (IFSB, 2007). The idea of profit- and loss-risk-sharing highlights the clear differences between Islamic and conventional banks in terms of funding and activity structures. However, this is not the case from the perspective of ‘three big international’ credit rating agencies in assessing the credit strength of Islamic banks.

They do not differentiate them sufficiently enough from conventional banks when requesting a credit rating. As one of the world’s leading credit rating agencies, Standard & Poor’s uses the same basic conventional principles, set of criteria, analytical framework and rating methodology when assessing Islamic banks. Standard & Poor’s view is that like conventional banks, Islamic banks are involved in intermediating cash flows, and share in the same risk categories (Standard & Poor’s, 2006). Similarly for Moody’s, its overall rating process for assigning ratings to Islamic banks and to the various classes of their funding instruments does not materially differ from that which is applicable to conventional banks. Moody’s believes that its criteria and methodology to form its credit opinions on financial institutions globally are flexible enough to encompass the subtle characteristics of Islamic banks, and the differences they may display in terms of their funding structures (Hassoune, 2008; Howladar & Chen, 2014). In rating Islamic banks, Fitch also assesses the risk profile of an Islamic bank in the same way it looks at conventional banks. The analytical framework used is the same including an examination of its financing and lending policy, risk diversification practices and the general management prudence (Fitch, 2007).

In the context of Shariah compliance, there is no single component in the rating approach by the major credit rating agencies to measure the Shariah compatibility of a bank’s functions in an Islamic framework. Standard & Poor’s does not conclude on the suitability of a particular obligation from the perspective of Shariah compliance. Standard and Poor’s is consistent with its tradition of being conservative and due to its familiarity with conventional standards, it addresses only the credit aspects of the transactions, to ensure transaction security without factoring in Shariah compliance into its ratings. Furthermore, in Standard and Poor’s effort to maintain neutrality, it has long contended that a rating does not constitute a recommendation to buy, sell, or hold a particular security and neither does it comment on the suitability of an investment for a particular investor. Thus its ratings are based on an assessment of the issuer’s ability and willingness to meet its financial obligations in a timely manner, without commenting on Shariah compliance.
Shariah compliance is not featured in any of Standard and Poor’s rating analysis (Al-Amine, 2011) and this also applies to Moody’s and Fitch. Moody’s analysis does not extend to forming an opinion on whether or not a transaction, a security, or an issuer, is complying with Shariah law, and therefore credit ratings should not be interpreted as addressing this issue per se (Hassoune 2008). Fitch claims that it is not in a position to determine what is or is not consistent with Islamic principles. Fitch does not approve, certify or evaluate Shariah compliance and emphasizes that Shariah compliance is a complex and specialized area that should be addressed by Shariah scholars (Wan, Liew, & Gohil, 2010).

In general, the Shariah aspects in rating Islamic banks are only considered by international credit rating agencies such as Standard and Poor’s, Moody’s and Fitch in very limited circumstances. They do not sufficiently address acknowledged differences between Islamic banking and conventional banking. The available rating products are primarily focused on credit risk and their analytical frameworks do not accommodate the unique features of Islamic banks. They do not recognize the mutually dependent nature of credit and fiduciary risks in Islamic banks. In this respect, such ratings do not consider the peculiarities of Islamic businesses. This premise further leads to the question whether evaluating the functions of Islamic banks and Islamic financial institutions from the Shariah point of view is possible.

5.2 Is it possible to assess the level of Shariah compliance of Islamic banks?

Owing to the nature of Islamic banking that compliance with Shariah is mandatory, some Islamic scholars believe that it is possible to do a thorough Shariah assessment using a well defined and comprehensive process. This process needs to include a critical examination of the resources available to a Islamic bank for Shariah compliance and structured procedures being put in place to guide all its activities (Zaidi, 2008). The Islamic banking industry could adopt a similar CAMELS framework that is used in conventional banks when designing an appropriate rating system for Islamic banking (Muljawan, 2005; Song & Oosthuizen, 2014). However, it would only be effective with some improvements and modifications in order to adopt the typical differences in the Islamic banks’ operations (Sarker, 2008). The difference would focus on several aspects such as: (1) the agency role in the capital assessment, (2) value added distribution, (3) identification of risks which do not appear in the conventional banks, and (4) the incorporation of Islamic values and norms which particularly emphasize professionalism, competence to promote conducive and a friendly atmosphere in the organization. There are other Islamic values besides transactional Shariah compliance (Muljawan, 2005). The very nature of these tasks suggests that the assessment has to be carried out jointly by agency experts and Shariah scholars when analyzing and rating, the latter group being independent of the influence of the rated entity (Zaidi, 2008).

The practitioner perspective with reference to rating Islamic banks can be obtained from some other Islamic rating agencies found in Malaysia, the world’s largest issuer of sukuk. One is Rating Agency Malaysia (RAM) and the other is Malaysian Rating Corporation Berhad (MARC). In rating Islamic banks, RAM has acknowledged the significance of the risks that are unique to an Islamic bank. Therefore, RAM takes into account the unique features of Islamic banks, i.e. interest-free loans and relevant Shariah codes that apply to Islamic financial institutions, in supporting the conventional analytical framework of Total Risk Assessment (TORA) and CAMEL (Capital Adequacy, Asset Quality, Management, Earnings and Liquidity) (RAM, 2008). Since the Shariah compliance is strongly linked to an Islamic bank’s reputation risk, RAM examines the mechanisms and internal controls used by the banks to ensure Shariah compliance on a daily basis, in the context of Shariah governance guidelines according to the jurisdiction respectively (RAM, 2010). RAM also reviews an Islamic bank’s adoption of guidelines or best practices as recommended by prudential Islamic finance organizations such as the Accounting and Auditing Institution for Islamic Financial Institutions (or AAOIFI) and the Islamic Financial Services Board (or IFSB), where applicable. Another credit rating agency, MARC, also employs the same CAMELS framework when designing an appropriate rating system for Islamic banking, but with some improvement and modifications that are required in Islamic banking operations.
The inherent need is to analyze the composition of the underlying asset portfolio – *muḍharabah*, *musharakah* and Treatment of Profit Sharing Investment Accounts (PSIAs) – so that they are not liabilities in the conventional sense. Another unique approach in rating Islamic banks is fiduciary rating since MARC focuses on the *Shari’ah* framework and considers adequacy of processes, practices and procedures for *Shari’ah* compliance as well as compliance with laws and regulations (MARC, 2012). MARC has appointed its own *Shari’ah* Advisory Panel to advise on *Shari’ah* matters of Islamic financial institutions and review new or variations to Islamic rating products and rating definitions so that they are compatible with *Shari’ah* requirements.

Although RAM and MARC have added *Shari’ah* assessment factors to their credit methodology, it is worth noting that their rating assignment is limited to domestic Islamic banks in Malaysia. Since the credit rating industry is a highly concentrated one, there are ‘big three’ credit rating agencies controlling approximately 95% of the ratings business. Moody's Investors Service and Standard & Poor's together control 80% of the global market, and Fitch Ratings controls a further 15% (Alessi, 2013), hence confirming they are firmly engaged in the global capital market. Although the Islamic International Rating Agency (IIRA) based in Bahrain provides a rating spectrum that encompasses the full array of capital instruments and specialized Islamic financial products, it will not be possible for it to rate the thousands of counterparties with whom banks deal (Chapra, 2007; Chapra & Ahmed, 2002). This position compels Muslim investors and stakeholder institutions to obtain a credit rating from the leading international credit rating agencies in making investment decisions. As such, the lack of credit rating agencies to increase the transparency of the Islamic financial market and enhance corporate governance, must be urgently addressed by the international regulatory community.

As for the international credit rating agencies, their approach to rating Islamic banks still needs further development and refinement, especially since compliance with *Shari’ah* is currently not part of their remit. It is very important for them to review their position to differentiate between the conventional banking industry and the Islamic financial industry. There is a need to devise a special mechanism to classify Islamic *Shari’ah*-compliant institutions and products by taking into account the Islamic Financial Services Board (IFSB) standards7 that govern this industry. The major credit rating agencies should demonstrate that their analysts have expertise that is relevant to Islamic finance industry sector. Otherwise the credit rating being issued by these agencies will not be accepted because they do not reflect the truth and because they are inconsistent with the IFSB guidelines and result in limited use to investors and other stakeholders in the Islamic community.

6. Conclusion

Since Islamic finance is playing an increasingly important role in both the Muslim and non-Muslim finance markets, it is useful to explore the often subtle particularities of Islamic finance, especially when it comes to rating its funding instruments. The importance of credit rating for Islamic banks is that all Islamic banks will not have the same level of commitment to *Shari’ah*. In the meantime, it is logical that Islamic banks will not have the same level of responses to the dynamic *Shari’ah* compliance process, so their level of compliance will also differ. This is where the role of credit rating agencies comes into play; to communicate this differential in the level of compliance to investors and regulators. It is therefore very important for credit rating agencies to consider *Shari’ah* compliance or *Shari’ah* risk when making an opinion regarding an Islamic bank’s overall creditworthiness and its capacity to satisfy its financial obligations. It seems that the CAMEL rating system or current rating methodology for conventional banks cannot qualify as an adequate and appropriate system for Islamic banks when assessing their performance.

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7 See IFSB, 2008, Guidance note in connection with the Capital Adequacy Standard: recognition of ratings by External Credit Assessment Institutions (ECAIS) on *Shari’ah*-compliant financial instruments. The guidelines issued by the IFSB set the record straight with reference to a special mechanism being required for classifying Islamic *Shari’ah*-compliant products and institutes.
The Islamic rating approach needs to be refined in order to achieve results similar to the conventional financial system by accommodating the unique features of Islamic banks. Islamic banks should be assessed beyond credit risk and corporate governance, and establish a more comprehensive criterion to judge their stability, one that recognizes the mutually dependent nature of credit and fiduciary risks. In this regard, the Islamic bank rating system is expected to benefit the supervision process as it could reflect the operational soundness more objectively. The rating system would then be used as the basis to formulate supervisory actions. Therefore the rating system designed should be able to locate problems that occur in Islamic banks more precisely.

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