

Article Title: ARCHIVE | General Criteria: Two Aspects Of Rating Sukuk: Sharia Compliance And Transaction Security Data: (EDITOR'S NOTE: —This criteria is no longer current. It has been superseded by the article titled, "Standard & Poor's Approach To Rating Sukuk," published on Sept. 17, 2007.) Standard & Poor's has rated a number of Islamic law (or "sharia") compliant transactions, mostly issued by sovereign, supranational, regional, or government-supported entities. One type of obligations issued for sharia-compliant transactions is the "sukuk" or Islamic notes (For a full list of sukuk rated by Standard & Poor's, please see table 1 at the end of the article.) In recent months, market participants have asked Standard & Poor's about various aspects of our rating process for sukuk. Two areas have received particular attention. The first of these is whether Standard & Poor's factors sharia compliance into its ratings. For reasons set out below, sharia compliance has not featured in Standard & Poor's rating analysis. The second area concerns the rating treatment afforded to ijara sukuk (lease-backed obligations) and related structures. Ijara sukuk are generally structured as sale-leasebacks with purchase obligation components (although there have been headlease-sublease structures as well). Transaction assets are sold to the issuer and leased back to the seller. Lease cashflow is thus the primary component of debt service. These obligations are also subject to a repurchase obligation triggered on the occurrence of certain conditions. The issue under review concerns the evaluation of such a repurchase obligation and how it is factored into Standard & Poor's analysis. Sharia And Ratings As with other types of rating, a Standard & Poor's rating of an Islamic bond addresses solely the likelihood of scheduled payment according to the terms of the bond. Standard & Poor's does not pronounce on the suitability of a particular obligation from the perspective of sharia compliance. This position is consistent with Standard & Poor's long-held position that a rating does not constitute a recommendation to buy, sell, or hold a particular security. In addition, a rating does not comment on the suitability of an investment for a particular investor. One consideration in the rating, however, is the determination of the bond's legal enforceability. Standard & Poor's bases its rating opinion on the compliance of any transaction with applicable commercial law—for example, English law, New York state law, and the commercial codes of the countries like United Arab Emirates (UAE) and the Kingdom of Bahrain (foreign currency A-/Positive/A-2). Accordingly, a Standard & Poor's rating does not address compliance with sharia law as a matter of enforceability through commercial tribunals. Standard & Poor's understands that sharia derives from religious sources such as the Koran, accounts of the life of the prophet, and scholarly consensus. In certain countries, sharia touches almost every aspect of life including social policy, banking, commercial, and economic relationships, while in others its primary influence is in the area of social policy, such as inheritance and divorce matters, with commercial codes (usually derived from continental European and Egyptian antecedents) governing business and contractual matters. All sukuk rated by Standard & Poor's are structured with the approval of a sharia board. The board evaluates the structure and substance of the transaction and pronounces on its compliance with sharia. Consistent with its position on addressing only the credit aspects of the transaction, Standard & Poor's does not review the role or composition of the sharia board, nor does it opine on the validity of that board's recommendations and decisions. Standard & Poor's also understands that other sharia boards are not precluded from disagreeing with a decision that a particular obligation is sharia-compliant. Should another sharia board question a finding of sharia compliance, however, this fact would not be likely to affect the obligation's enforceability, which is determined by commercial law. Nevertheless, should another sharia board disapprove, the transaction's liquidity may be affected, as investors may be reluctant to invest in the transaction. From the Islamic investor's perspective, the transaction must satisfy two regimes: applicable commercial law, as well as sharia. The investor is concerned not only with the enforceability of an obligation strictly from the standpoint of contract and commercial law, but also with its compliance from the sharia perspective. (An appropriate investment analogy might be so-called "green" bonds targeted to environmentally conscious investors whose issuers comply with, for example, the CERES Principles, with the bonds being legally enforceable as a matter of course.) In practice, suitability for the Islamic investor appears to focus on whether the obligation could, for sharia purposes, be seen to transgress the sharia prohibition on charging interest. Were a particular transaction governed solely by sharia, issues such as uncertainty of outcome in a sharia court could adversely affect the rating. Indeed, Standard & Poor's understands that certain sharia-compliant obligations have disavowed sharia governing law as a matter

of form, although they may satisfy sharia requirements as a matter of substance. To the extent that sukuk are governed solely by sharia and are subject to the jurisdiction of sharia courts then a declaration by such courts that the sukuk do not comply with Islamic law could render the sukuk unenforceable. This eventuality would, of course, be factored into the rating. Repurchase Obligations In Ijara Sukuk And Other Structures Among other sharia-compliant transactions, Standard & Poor's has rated ijara sukuk based on the sale-leaseback and headlease-sublease models (see chart 1). Under the sale model, a party sells assets to an issuer who raises the purchase price from the proceeds of an issuance of holds title thereto. In certain transactions, the assets are leased back to the seller who pays rent for the use of the assets. Rent payments are applied to debt service payments on the sukuk. In other transactions, cash flow from the assets apart from rent from the seller-lessee is applied to debt service payments on the sukuk. To date, rated "sale model" transactions have featured a contractual obligation from the seller to repurchase the transaction assets in the event of a default for a price equal to the amount outstanding under the rated obligation. In a transaction where debt service depends initially on asset performance, the repurchase obligation performs the role of insulating the transactions' ratings from the performance of the underlying assets. By contrast, in the headlease-sublease model, the actors remain the same, but instead of selling assets, the owner headleases them to the issuer, who leases them back to the owner. In headlease-sublease ijara sukuk, there will not be an obligation to repurchase the transaction assets (which in this case comprise only a lease). Although the ultimate credit risk is still the sub-lessee, the sub-lessee may simply provide a quasi-guarantee on payments due to the sukuk note holders. The \$250 million Bahrain Monetary Agency International Sukuk Co. (BMA) sukuk (rated 'A-') issued in June 2004 was based on headlease-sublease and there was no repurchase obligation on behalf of the BMA. The sukuk payments were serviced by the sub-lessee (the Kingdom of Bahrain acting through the Ministry of Finance and National Economy) and the government's payment obligations were a direct, unconditional, unsubordinated, unsecured, and general obligation of the government, backed by the full faith and credit of the Kingdom of Bahrain (foreign currency A-/Positive/A-2). By comparison, in the Gold Sukuk dmcc transaction (rated 'A') undertaken by the Dubai Metals and Commodities Centre Authority (DMCC; A/Stable/A-1), the sales of three residential tower complexes were supporting the musharaka sukuk (joint-venture backed obligations) issued by DMCC (see chart 2). In the event of the assets failing to perform, there was an obligation on DMCC to purchase musharaka units from the issuer and not the commercial property per se. In each case, the notes are more akin to guaranteed obligations than to the non-recourse secured obligations characteristic of RMBS or CMBS transactions. The analysis of the repurchase obligation is an important factor in the rating of the transaction. Standard & Poor's not only analyzes the legality of the purchase obligation, but also assesses the willingness of the originator to honor that repurchase obligation. The legality is assessed in two ways. First, a legal analysis is undertaken to determine whether the law of the country where the transaction is taking place imposes any seniority among an originator's payment obligations. For example, in ijara sukuk transactions with an obligor whose repurchase obligation backed the transaction, Standard & Poor's rated the sukuk on a par with the ratings on the obligor, based on a legal opinion indicating that the obligor could contractually agree to rank its rent payments on a par with its debt obligations. The wording of the repurchase obligation is also important to ensure timeliness of payment. Particular emphasis is placed on the conditionality and revocability (if any) of the obligations. In cases featuring sovereign repurchase obligations, appropriation risk may have to be taken into account. Second Standard & Poor's analysis is not limited to the legal matters. Standard & Poor's also assesses the willingness of the obligor to honor its repurchase obligations. As part of this analysis, Standard & Poor's examines the importance of the sukuk to the repurchase obligor. This analysis is particularly relevant when the originator is a sovereign entity (as a sovereign can change its own laws). Finally, because the originator's repurchase obligation generally flows to the issuer and not to the ultimate sukuk holders (sukuk holders are not secured by a pledge of security, but are equivalent to owning an indirect proportional interest in the assets of the issuer), the analysis of the issuer is also important in understanding whether there are risks that the issuer would not act as a conduit of funds from the originator to the sukuk holders. As an aid to this analysis, it may be advisable for the issuer to be structured as a bankruptcy-remote special purpose entity (SPE). In principle, Standard & Poor's is open to rating transactions whose rating depends solely

on the performance of the assets owned by the issuer. Standard & Poor's would likely analyze the performance risk of such assets based on its conventional methodologies. For example, if the underlying asset is a project, Standard & Poor's would use project finance methodology. Any risks that would be raised as a result of the transaction's compliance with sharia will be analyzed on an ad hoc basis.

**Table 1 Sukuk Financing Ratings History**

ORIGINATOR	DATE OF FIRST RATING	ISSUE AMOUNT	RATINGS*
Malaysia Global Sukuk Inc.	June 10, 2002	\$600 million	A-
Kingdom of Bahrain	Sept. 04, 2002	\$80 million	A-
Kingdom of Bahrain	Nov. 11, 2002	\$50 million	A-
Solidarity Trust Services Ltd. (Guarantor: Islamic Development Bank)	Aug. 11, 2003	\$400 million	AAA
Qatar Global Sukuk QSC	Sept. 10, 2003	\$700 million	A+
Bahrain Monetary Agency International Sukuk Co.	Feb. 18, 2004	\$250 million	A-
Stichting Sachsen-Anhalt Trust	July 9, 2004	€100 million	AA-
Loehmann's Capital Corp. (Guarantor: Loehmann's Holdings Inc.)	Sept. 22, 2004	\$110 million	CCC+¶
Sarawak Corporate Sukuk Inc.	Nov. 30, 2004	\$350 million	A-
Pakistan International Sukuk Co.	Dec. 23, 2004	\$600 million	B+
Gold Sukuk dmcc (Guarantor: Dubai Metals and Commodities Centre Authority)	April 11, 2005	\$200 million	A
Islamic Development Bank	May 20, 2005	\$1 billion	AAA

\*Senior unsecured debt rating unless otherwise indicated. ¶Senior secured debt rating. All ratings as of Jan. 9, 2005.