Article Title: ARCHIVE | General Criteria: Rating Sukuk--How Rating Methodologies Apply to Islamic Debt Financing Data: (EDITOR'S NOTE: —This criteria is no longer current. It has been superseded by the article titled, "Standard & Poor's Approach To Rating Sukuk," published on Sept. 17, 2007.)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 Standard & Poor's Ratings Services has rated three sovereign "sukuk" (Islamic bonds), issued by the Kingdom of Bahrain (foreign currency A-/Stable/A-2; local currency A/Stable/A-1), the Federation of Malaysia (foreign currency BBB+/Stable/A-2; local currency A+/Stable/A-1), and the State of Qatar (A+/Stable/A-1). All three sukuk were designed in accordance with Islamic principles on the provision and use of financial services and products. To achieve the same ratings as assigned to the sovereigns' direct, unsecured debt obligations, the sukuk were based on "ijarah" or lease contracts, and incorporated unconditional, irrevocable guarantees and/or purchase agreements. Standard & Poor's also rates the Islamic Development Bank (foreign currency AAA/Stable/A-1+) and other financial institutions that provide Islamic banking and insurance services. Standard & Poor's expects to rate more Islamic debt instruments, and of different types, over the near term. While the provisions of Islamic debt instruments may add levels of complexity to the analysis, longstanding methodologies and rating scales are sufficiently broad so far to incorporate the varied features of Islamic debt financing. Islamic financing largely centers on asset-backed approaches and sometimes involves a degree of risk-sharing more commonly borne by equity investors. In practice, however, as illustrated in the sukuk that Standard & Poor's has rated, binding guarantees and other contractual obligations can place transactions firmly in the debt category. Standard & Poor's credit rating analysis focuses on the specifics of the transaction, the robustness of the associated contracts, and any special features indicating that the underlying borrower will treat the obligation as it would direct, unsecured, commercial financial obligations. Islamic financing is evolving in a multitude of ways. Islamic financing follows the principles of "Shariah" (Islamic law). Central to these are: A prohibition on the payment of interest ("riba"); The inability to engage in excessive risk-taking or speculation ("gharar"); Limitations on the sale of financial assets and their use as collateral; The nonbinding nature of most commercial contracts not involving sales, leases, or assignments; and An exclusion from certain industries, such as those involving pork, alcohol, or gambling. Payments to investors and depositors result not from the use of capital, but from the fact that they directly bear risks relating to specific economic activities, usually related to the performance of an explicit asset. The risk-sharing may be in accordance with predetermined profit-and-loss sharing ratios, or it may more closely resemble conventional financing in its reliance on the performance of a lease or a trade agreement. Islamic debt securities can take a multitude of forms depending on the nature of the assets underlying the transaction and the particularities of the transaction. The diversity of Islamic instruments reflects the absence of uniform international Islamic standards, the resulting varied interpretations of Islamic principles, and diverging regulatory and supervisory practices across Islamic countries, predominantly between Asian and Middle Eastern countries. The recent creation of the Islamic Financial Services Board in Kuala Lumpur (a joint effort of the Islamic Development Bank, the IMF, and the Accounting and Auditing Organization for Islamic Financial Institutions) should help standardize regulatory frameworks and prudential supervision. Islamic law related to banking and finance is one of the most rapidly changing areas of Islamic law, stemming in part from the rapid development of the banking and finance sectors over the past two decades. Conformity with Islamic principles is reviewed by various Shariah boards, the Organization of Islamic Conferences' Fiqh (Understanding) Academy being the most prominent. The latter includes scholars from member countries. Standard & Poor's does not form opinions on whether a financial instrument is in accordance with Shariah principles, but analyzes creditworthiness in the context of a broad array of capabilities and incentives. An Islamic debt instrument can receive a rating as high as that on the direct, unsecured debt obligations of the underlying borrower if the performance risk of the asset upon which the transaction is based is minimized. Depending on the asset involved, as with other secured debt, a rating exceeding the rating on direct, unsecured obligations may be assigned, although this is less likely in the case of sovereign governments because of the wide latitude that they have in situations of political and economic stress. The prohibition of riba (interest) and gharar (speculation) poses no rating difficulties. While Islamic law prohibits predetermined interest payments and undue speculation, it implicitly recognizes the time value of money, and the depositor or creditor is allowed to receive a return. In general, the return has to be linked to the specific risks taken, with the recognition that the original investment is also at risk, to varying degrees of course, as with conventional finance. Along these lines, insurance usually is not allowed under Islamic law unless it is cooperative or mutual insurance, because only in these cases are the interests of the insurer and the insured sufficiently linked. "Takaful" is a form of Islamic mutual insurance based on the principle of mutual assistance. Islamic principles dictating that providers and users of capital share risks and rewards mean that, often, the rate of return can only be determined ex-post, based on actual profits accrued from real sector activities. However, the rated Bahraini, Malaysian, and Qatari sovereign sukuk rest on pre-set rental payments, so that a firm expected rate of return can be determined. The ban on gharar also prohibits the sale or pledging of financial assets in most circumstances. This limits the use of many risk-hedging instruments and techniques, and stands in contrast to more conventional finance, where the use of swaps and other derivatives is widespread. Restrictions on the trading of financial assets also preclude the development of a secondary debt market. While Islamic law has different rules for the trading of specific assets, in many cases forward sales are restricted. Ordinary credit sales, in which a particular existing asset is sold for payment later, are permitted. While some of these restrictions may impede the development of efficient capital markets, they do not preclude the development of ratable debt instruments. Nonbinding contracts and weak guarantees may present rating challenges. Standard & Poor's will generally assign low ratings to transactions that include nonbinding contracts and the nonbinding appointment of agents. Under Islamic law, many contracts become binding only after one party has performed. Pledges usually become binding only upon delivery of the pledged assets, and the pledgee's ability to use his/her pledge is restricted. However, if the Islamic contracts are enforceable under secular law, contracts are more likely to be upheld as binding. "Lazim" or binding contracts under Islamic law include those involving sales, leases, and assignments. Guarantees can be provided to ensure the payment of commercial financial obligations. Guarantees must be provided free of charge. The guarantor can cancel at any time before the guarantee is exercised. These risks can be, and have been, mitigated in various ways. Recovery after default may be inhibited by a debtor-friendly approach. The Qu'ran and Shariah law encourage leniency by creditors toward a debtor if the latter is in difficulty. At the same time, failure to pay by a solvent debtor is a criminal offence, although punishment is rare, given the slow pace of court proceedings. However, in relevant jurisdictions, recovery of pledged security under secular law may protect creditors significantly and impact the incentives relating to default. Hence, the security position of lenders will vary from jurisdiction to jurisdiction, as it does with conventional debt structures. Islamic financing contracts unrelated to profit-sharing compare most closely to conventional debt financing. A "murabaha" contract entails the sale of goods at cost plus a margin and is widely used in trade financing. Generally, the margin is related to the cost of funds, including credit risk, and may be based on various conventional benchmarks (such as LIBOR), although the development of Islamic benchmarks is under consideration. Murabaha-contract-based zero-coupon bonds are popular in Malaysia. A "bai bithaman ajil" contract is a long-term murabaha contract where the payment is deferred or made in instalments. The Islamic Notes Issuance Facility, which raised funds for the construction of the new Kuala Lumpur International Airport, is based on the concept of bai bithaman ajil. Ijarah is a lease contract. The duration of the lease and the lease payments are agreed in advance, and ownership of the assets remains with the lessor. In a sale and lease-back arrangement, the lessee sells the assets to an issuer-lessor (often a special-purpose vehicle), which leases them back to the lessee at a predetermined rental rate. At the end of the lease term (usually equal to the tenure of the bond), the parties may agree to transfer the ownership of the assets to the lessee. The rated sukuk of Bahrain, Malaysia, and Qatar incorporate commitments for the governments to buy back the leased assets at a price sufficient to meet the sukuk obligations. In each case, the government also had a strong commitment to continue leasing the assets in accordance with the ijarah contract until the end of the lease period--via a guarantee in the case of Bahrain, and via the high priority of lease obligations in the cases of Malaysia and Qatar. Islamic financing contracts allowing future asset sales are amenable to ratable debt transactions. A "bai'salam" or "bai'salaf" contract authorizes the sale of a specific quality and quantity of a commodity or manufactured product to be delivered to the purchaser on a fixed date in the future at a price paid in advance. A major risk is that the seller will not meet the obligations for which he has already been paid. If the seller cannot deliver the goods, the buyer needs to wait until the

seller can do so, or the buyer can claim the amount initially paid, but without compensation. The buyer cannot resell the goods before actually taking possession of them, although another contract with a third party is possible. An "istisna" contract sells a manufactured product or a service at an agreed-upon price that would normally cover the cost of production and a profit, with delivery on a fixed date in the future. The price is paid in instalments as production progresses. The contract is not binding until the product is completed and accepted by the buyer. The seller may enter into another istisna contract with a subcontractor. For example, a financial institution can undertake the construction of a facility for a deferred price, and subcontract the construction of the facility to a construction company. When a bank acts as an intermediary, the contractor is no longer exposed to the customer's credit risk, creating a kind of insurance, the premium for which is equal to the bank's compensation. Profit-sharing Islamic financing contracts resemble equity financing, but may evolve to be used in debt financing. A "mudaraba" contract is a promise to pay the investor a return linked to the profits (or losses, excluding any losses on the initial capital investment) from the project or activity being financed. The return cannot be a lump sum or guaranteed amount. The investor shares the profits/losses from the project with the entrepreneur according to an agreed formula, but financial losses are borne exclusively by the investor, who has provided all the capital. The entrepreneur is solely responsible for running the business. In some cases, a third party (the government, for example) may compensate for losses. Islamic laws also authorize the creation of reserves from profits to provide protection from losses. Mudaraba contracts are often used in short-term investment projects and in trade and commerce. Mudaraba bonds resemble revenue bond financing, in which bondholders are solely dependent on the revenue generated by the project being financed. An important difference is the lower ranking of the investor's claim in a mudaraba contract, because of the more equity-like dependence on profits. In some Islamic countries, the central bank provides medium-term refinancing to commercial banks under the mudaraba system. A "musharaka" contract is similar to a mudaraba contract, but with multiple investors who, in proportion to their share of the investment, have the opportunity to monitor and influence the business in which they invest (notably, via the exercise of voting rights). Profits and losses are shared according to the respective capital contributions. Musharaka contracts are usually used in long-term investment projects. Musharaka contracts have been used to finance banks (in Sudan), highways (in Tehran and Istanbul), oil-drilling facilities (in Malaysia), and government deficits (in Iran). Appendix The following relevant articles have been published by Standard & Poor's. They are available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. Alternatively, call one of Standard & Poor's Ratings Desks: London (44) 20-7847-7400; Paris (33) 1-4420-6705; Frankfurt (49) 69-33-999-223; or Stockholm (46) 8-440-5916. Members of the media may contact the Press Office Hotline on (44) 20-7826-3605 or via media_europe@standardandpoors.com. "Qatar Global Sukuk QSC's Proposed Trust Certificates Due 2010 Rated 'A+'" (Sept. 10, 2003) "Solidarity Trust Services Limited Notes Assigned Preliminary 'AAA' Rating" (June 30, 2003) "Islamic Development Bank" (Feb. 3, 2003) "Classic Ratings Approach Applied to Islamic Banks Despite Industry Specifics" (Nov. 27, 2002) "Kingdom of Bahrain's Proposed Islamic Leasing Bonds Assigned 'A-' Rating" (Nov. 11, 2002) "Malaysia Global Sukuk Inc.'s Trust Certificates Rated 'BBB'; Outlook Positive" (June 10, 2002) Analyst E-Mail Addresses
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