Article Title: ARCHIVE | General Criteria: Standard & Poor's Approach To Rating Sukuk Data: (EDITOR'S NOTE: — These criteria are no longer current. They have been superseded by "Methodology For Rating Sukuk," published Jan. 19, 2015. We originally published this criteria article on Sept. 17, 2007. When originally published, this article superseded the articles titled "Two Aspects Of Rating Sukuk: Sharia Compliance And Transaction Security," published Jan. 12, 2006; "A Closer Look At Ijara Sukuk," published Feb. 2, 2005"; and "Rating Sukuk -- How Rating Methodologies Apply to Islamic Debt Financing," published Sept. 15, 2003.) Executive Summary An unprecedented surge in sukuk issuance during the past three years has provided different categories of issuers--sovereigns, corporations, and banks--with an alternative way to structure their funding. Standard & Poor's Ratings Services estimates sukuk outstanding worldwide to be in excess of $80 billion at June 30, 2007. Over two-thirds are unlisted, over-the-counter instruments, with the remainder listed. The number and size of listed sukuk are increasing fast, the largest being that issued by Dubai-based Nakheel Group in early 2007 for $3.52 billion, listed in London and Dubai. As of Sept. 17, 2007, we rated $12 billion in sukuk outstanding listed on the world's markets, and we believe the volume of rated sukuk is set to rise due to the rapid development of this type of financing. Through our rating of Sharia-compliant issuers and issues over a number of years, we believe we have demonstrated a deep and global understanding of Islamic finance. Standard & Poor's understands that in structuring sukuk, parties endeavor to ensure that: Rights and obligations of both the issuer and investors are clear and transparent, in compliance with the principle of Islamic finance that bans "gharar" (uncertainty); Income from securities is related to the purpose of the funding, and does not simply comprise interest payments--abiding by the principle that bans "riba" (usury or interest); and Securities issued are backed by yields derived from identified tangible underlying assets, according to the principle that all financial transactions must be asset backed, or at least asset based. In light of these principles, sukuk lie on a continuum ranging from the lowest profit-sharing structures (typically guaranteed sukuk with a predetermined rate of profit ranking pari passu with the obligor's other obligations) to the highest profit-sharing structures (nonguaranteed sukuk behaving like ABS and issued by pass-through or pay-through vehicles.) In Arabic, "sukuk" is the plural, generic term for "notes," "certificates," or "bonds." In practice, the market now commonly uses the term generically to refer to debt instruments compliant with Sharia, or Islamic law. In this report, we identify three broad categories of sukuk, and describe our ratings approach for each. Standard & Poor's Approach To Rating Sukuk Summarized Our ratings are an opinion about the ability and willingness of an issuer to meet financial obligations in a timely manner, without commenting on Sharia compliance. The rating on an Islamic debt instrument varies depending on the degree of performance risk of the asset backing the transaction. Depending on the collateral type and transaction structure, the issue rating may be higher than the senior unsecured rating on the obligor. There are various ways to structure sukuk: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) lists 14 structures. In practice though, issuers have made use of only a handful of sukuk structures, including "ijara" (lease-back) deals and "musharaka" (co-ownership) contracts. Notwithstanding the potential variety of sukuk structures, we group them into three broad categories: Sukuk with full credit-enhancement mechanisms Under this structure, sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral. The guarantor provides Sharia-compliant shortfall amounts in case the issuing vehicle (usually a special-purpose entity or SPE) cannot make payment. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the sukuk (usually senior unsecured) among other financial obligations of the guarantor. Sukuk with no credit-enhancement mechanisms Under this structure, sukuk resemble ABS in a securitization. The pool of underlying assets serves as the sole basis for coupon and principal payment. The ratings on these sukuk are largely based on the ability of the underlying assets to generate sufficient cash to meet, in a timely manner, the SPE's obligations. Standard & Poor's ratings, in this particular case, are based on the performance of the underlying assets under different stress scenarios along with the expected value of these assets at maturity. Sukuk with partial credit-enhancement mechanisms This structure combines features of both of the first two categories, with a third-party guarantee absorbing limited shortfalls from an otherwise asset-backed transaction. Our ratings approach depends on our estimate of the capacity of the underlying assets to meet the SPE's financial obligations as well as the terms of the guarantee and the creditworthiness of the guarantor. To date, Standard & Poor's has assigned ratings to 23 sukuk issued by sovereigns, supranationals, regional governments, corporations, and financial institutions (see appendix 1). Most sukuk we rate benefit from full external guarantees, falling in the first category. We therefore have assigned them ratings equivalent to those on their guarantors and view them as ranking pari passu with the senior unsecured obligations of guarantors. In the longer term, we foresee increasing issuance of more complex sukuk with no credit enhancement mechanisms, which would fall into the second category. More generally, we expect securitization, particularly in the Middle East, to increase and to take the form of Sharia-compliant structured transactions, giving rise to asset-backed sukuk notes with limited or no guarantee from the asset originator. The tranching of liabilities, a conventional securitization tool, is still under discussion among Sharia scholars regarding compliance, although a few tranched mortgage-backed sukuk have already been issued in Malaysia and the Gulf region, as well as asset-based subordinated sukuk. Rating Sukuk With Full Credit-Enhancement Mechanisms: The Most Common Type of Rated Sukuk Among credit-enhanced or guaranteed sukuk, Standard & Poor's rates "istisna" (project), "mudharaba" (trust financing), "musharaka" (co-ownership), and "ijara" (leasing) structures. Ijara contracts so far have been the most popular form of sovereign-issued sukuk. For banks, musharaka contracts have been the most widely used and preferred route for issuing sukuk, as Islamic banks have only limited ownership of income-generating tangible assets to lease and lease back. Banks have therefore chosen to sell part of their credit and/or investment portfolios for the purpose of issuing sukuk. Usually, the seller of the underlying assets (the originator of these assets and guarantor) is also the manager or servicer. In rating guaranteed sukuk, we base our assessment on the creditworthiness of the guarantor. The guarantee covers not only the principal amount of the sukuk payable at the maturity date or in the case of predefined default events, but also the periodic payments (coupons) from the SPE to sukuk holders. One of the most important factors in assigning ratings in this sukuk category is the level of seniority of the originator's guarantee and, more precisely, whether it ranks pari passu with all other similar obligations of the guarantor. Example of fully guaranteed sukuk: sukuk al musharaka (co-ownership) issued by a bank The transaction structure involves an SPE issuing musharaka sukuk. The proceeds of the sukuk will ultimately be used for a specific or general purpose by the bank, which sells a given percentage of a pool of assets to the issuer. These assets, originated, leased, and managed by the bank, are co-owned by both the bank and the issuer. The latter holds a given percentage of the co-owned assets in a trust capacity for the benefit of sukuk holders, owing to the proceeds received from the issuance of the trust certificates, and for a period of time corresponding to the duration of the sukuk. The pool of co-owned assets is in this case made up of leasing (ijara) contracts between the bank and its customers, pertaining to residential properties and other assets. The lease rental payments on the co-owned assets are collected by the bank as the managing agent of the assets, and serve as the basis for the floating periodic distribution payments payable on the trust certificates. On dissolution of the trust, the bank is to purchase the portion of the co-owned assets held by the issuer at the agreed exercise price, which will fund the dissolution distribution amount that is payable to the certificate holders and is equal to the principal of the sukuk (see chart 1.) The guarantee of the bank--simultaneously originator, managing agent, and guarantor--is the most important rating factor. The rating on the sukuk is equalized with our rating on senior unsecured debt of the bank, as guarantor. The equalization reflects the bank's obligation to make up for any shortfall if rental payments from the co-owned assets are insufficient to make the coupon payments. This obligation ranks pari passu with all other unsecured and unsubordinated obligations of the bank as guarantor. The dissolution amount payable on the trust certificates at the dissolution date is also dependent on an obligation of the bank. This obligation is the irrevocable undertaking of the bank to purchase the issuer's portion of the co-owned assets at the agreed price. This structure was used by United Arab Emirates-based Sharjah Islamic Bank (BBB/Stable/A-2) for its five-year $255 million sukuk issued in 2006. Rating Sukuk With No Credit-Enhancement Mechanisms: Less Common, But Expected To Emerge In The Future The rating on this kind of sukuk would depend primarily on the ability of the underlying assets to generate enough cash flow to meet all of the issuer's financial obligations in a timely manner. In other words, the rating would depend mainly on the nature of the underlying assets. For example, if the underlying asset is a project, we would use our project finance methodology to estimate the value of the project and its ability to generate a sufficient amount of cash to pay the periodic installments and final principal repayment. Ratings on this kind of sukuk could be higher or lower than the ratings on the originator. We expect that this type of sukuk will become more popular in the foreseeable future in response to the huge number of projects in the planning stage, particularly in Gulf countries. Changes to regulation in the Gulf could give a boost to this type of sukuk. Banks and regulators in the Gulf are currently considering enhancing the legal framework surrounding mortgage financing for both commercial and residential properties. In the longer run, once sufficient mortgage loan volumes are booked on banks' balance sheets, Islamic securitization will become more attractive. Given their quality, which can be tracked statistically, and high granularity, mortgage loan portfolios would become good candidates for asset-backing the issuance of nonguaranteed sukuk. Residential and commercial mortgage-backed sukuk have been so far limited in number; the most recent was Cagamas MBS Berhad's Malaysian ringgit (MYR) 2.11 billion Islamic RMBS issued in Malaysia in May 2007. Both conventional and Islamic financial institutions might increasingly turn to this category of sukuk in the future, especially if portfolios are built on a larger scale; credit information pertaining to them is collected, stored, and documented; and the underlying legal framework is supportive, particularly of the legal isolation of assets for the benefit of investors. In rating this type of sukuk, we would likely focus on: (1) the ability of the underlying assets to generate enough cash to meet the SPE's sukuk payment obligations; (2) the capacity of the managing agent (often called "mudarib") to act as servicer and transfer payment from the obligors to the "rab el-maal" (investors); and (3) the expected value of the reinvested cash flows, compared with the principal amount of the sukuk. We would subject these three key elements to thorough analysis, based on modeling the behavior of the underlying mortgages and liquid instruments under different possible stress scenarios, as well as on documented assumptions about the recovery rates of the securitized asset classes. As for any other credit rating, we would also examine the supportiveness of the underlying legal framework, especially legal isolation of the assets from the originator's insolvency. Rating Sukuk With Partial Credit-Enhancement Mechanisms: Requiring A Case-By-Case Approach Encompassing A Wider Range Of Analytical Steps Partially credit-enhanced sukuk benefit from a third-party guarantee with respect to either periodic profit distributions or the principal amount, but not both. We see the partial guarantee as a mechanism enhancing the creditworthiness of the sukuk, but as such not providing enough for us to equalize the rating on the sukuk with that on the guarantor. Our rating approach for this type of sukuk is therefore based on two elements: An assessment of the overall creditworthiness of the sukuk on a stand-alone basis, which means an evaluation of the ability of the underlying assets to generate sufficient cash flow to allow the issuing SPE to meet its financial obligations. This step is similar to our approach in rating nonguaranteed sukuk, and considers the position of the managing agent in relation to the extent to which nonperformance of its functions would affect the sukuk's credit quality. The stand-alone rating could then be notched up, depending on the nature of the guarantee and the implied enhancement to the sukuk's overall creditworthiness. We assess the capacity of the guarantor to provide timely support to the SPE in case of need, as well as enforceability of the guarantee. We might also place some emphasis on recovery analysis, whenever feasible. This form of analysis can help determine the probability of payment of sukuk holders if adverse events negatively affect the underlying assets or the obligor and/or managing agent, causing default or inability to service required cash flow transfers. In many of the jurisdictions where sukuk are issued, recovery analytics remain difficult to implement. Example of a partially credit-enhanced sukuk: sukuk al istisna (project) involving an industrial issuer The transaction involves an SPE issuing sukuk based on the securitization of existing and future project receivables originated by the obligor (see chart 2.) The proceeds from the sukuk are often used in this type of structure for funding specific items of plants and equipment or designated capital costs. Revenues collected from the project are the basis for the periodic distributions on the sukuk. On the dissolution of the trust and sale of the project, proceeds fund the dissolution distribution amount payable to the certificate holders, and are equal to the principal of the sukuk. The guarantor funds any shortfall, allowing the SPE to meet its obligations under the sukuk. The guarantee is provided in this case for 50% of the dissolution amount, and constitutes an enhancement factor for the ratings, and an additional comfort factor for sukuk holders. The rating on istisna sukuk is based on the ability of the underlying assets to generate sufficient cash flow to meet debt service, expected value of the project at sukuk maturity, and also the credit enhancement provided by the partial external guarantee. The guarantor is committed to pay back up to 50% of the sukuk principal amount if the proceeds of the project sale fall short of the sukuk principal amount. Depending on the breadth of this partial credit-enhancement mechanism, we would assess how many notches to apply above the stand-alone rating on the sukuk. In this example, the guarantor does not guarantee the coupon payments. Our Experience In Rating Sukuk In The Infrastructure Finance/Corporate World Standard & Poor's has rated three sukuk in this particular field: The sukuk of National Central Cooling Co. PJSC (Tabreed; BBB-/Stable/--), issued by Tabreed 06 Financing Corp. Tabreed is an industrial company based in the United Arab Emirates (U.A.E.); The sukuk of DP World Ltd. (A+/Stable/A-1), issued by DP World Sukuk Ltd. DP World is also an industrial U.A.E.-based company; and The sukuk of Saad Trading Contracting and Financial Services Co. (STSFC; BBB+/Negative/A-2), issued by Golden Belt 1 B.S.C. STSFC is a Bahrain-based conglomerate. The three sukuk have been structured differently, but have much in common with sukuk that have full credit-enhancement mechanisms. There are, nevertheless, some interesting differences in the way we analytically became comfortable with the ratings assigned to each of the individual sukuk. Tabreed 06 Financing Corp. ('BBB-') The $200 million seven-year istisna and ijara sukuk is intended to fund the construction of district cooling plants in the U.A.E. by Tabreed. The sukuk issued by a 100%-owned SPE of Tabreed--Tabreed 06 Financing Corp--benefited from a purchase undertaking provided to the issuer by the parent. The purchase undertaking provides comfort that, in the event of insolvency of the issuer or payment shortfall, the parent has an irrevocable obligation to promptly pay all amounts due under the sukuk. We viewed this payment undertaking as equivalent to a guarantee, meaning that the sukuk could rank pari passu with Tabreed's senior unsecured corporate obligations. Had Tabreed's ratio of secured debt to assets been more than 20%, any unsecured debt would have been rated one notch below the counterparty credit rating (but when the sukuk was rated Tabreed's ratio was less than 20%.) Other features include the following: The trustee holds issuance proceeds in a transaction account in favor of the sukuk holders. The trustee also holds legal ownership over the assets in favor of the sukuk holders; A negative pledge over the assets is held by the trustee in favor of the sukuk holders; and The structure includes a cross-default clause and a cash waterfall structure linked to distributions, similar to those on Tabreed's other senior secured debt. DP World Sukuk Ltd. ('A+') For DP World's 10-year $1.5 billion sukuk, the parent, DP World Ltd. provided a purchase undertaking to the 100%-owned SPE (borrower). The purchase undertaking's wording was similar to that of Tabreed's. This usually would have led us to equate the rating on the sukuk with that on DP World's corporate obligations, on the assumption that the sukuk had debt-like features equivalent to those of unsecured debt. But because the instrument was structured as a trust-like sukuk--with periodic payments to sukuk holders funded from mudaraba (joint investment) assets, we instead viewed this sukuk as unguaranteed or otherwise unsupported issuance (excluding any potential role that government would play as 100% indirect owner of the parent). Standard & Poor's concluded that the sukuk carried some equity-like, loss-absorbing features that would have rendered the debt issue potentially less equal on a ranking status compared with other unsecured debt at DP World Ltd. Ultimately, we did not need to question the ranking status of the sukuk relative to other financings. The reason was our counterparty credit rating of DP World Ltd. was based on strong implicit government support for the entity, and we considered that the purchase undertaking provided to DP World Sukuk from its parent also benefited from strong implicit government support. The rating also reflected the strength of the purchase undertaking, which implied that in the event of insufficient payments from the mudaraba assets to meet distributions the shortfall payments by DP World Ltd. would rank pari passu with payments to DP World Ltd.'s other unsecured creditors. All these factors led us to equalize the rating on the sukuk with the counterparty credit rating on DP World Ltd. Golden Belt 1 B.S.C. ('BBB+') Golden Belt 1 B.S.C.'s $500 million five-year sukuk benefited from an unconditional and irrevocable undertaking by its 100% owner, STCFSC, to make rental payments on the leased assets plus the termination payment (principal) upon maturity of the sukuk. Due to the irrevocable nature of payments under the sublease agreement (just like that of the purchase undertakings in the DP World and Tabreed 06 sukuk,) we viewed the Golden Belt sukuk as ranking pari passu with all other unsecured and unsubordinated obligations of STCFSC. Given that STCFSC had no secured borrowings on its balance sheet, there was no issue of structural subordination and the rating was equalized with our long-term issuer credit rating on STCFSC. Standard & Poor's expects to continue to rate this type of sukuk at the same level as the rating on the parent's senior unsecured obligations. Generally, if the investment-grade parent has a ratio of secured borrowings and other priority liabilities (for example, trade creditors to strong subsidiaries) to assets of more than 20%, then we would likely notch down the rating on the sukuk and on the parent's senior unsecured debt relative to our long-term issuer credit rating on the parent guarantor. On the other hand, if we have sufficient comfort in the security and/or the parent balance sheet consists largely of unsecured borrowings, then we would likely equalize the rating on the sukuk with the rating on the parent. In addition, if the parent guarantor has a strong implicit government-derived rating, then we could factor in government involvement into our assessment of the sukuk financing at the SPE. Legal Considerations Standard & Poor's also takes into account the relevant legal and jurisdictional aspects of the transaction in rating a sukuk--no matter what kind. To understand the impact of the underlying legal framework on the ability and willingness of the issuer to make payments on the rated instruments, we may request legal opinions of counsel to analyze the relevant legal issues, such as enforceability, recognition of choice of law, and, particularly in the context of nonguaranteed sukuk, insolvency and security-related matters. Some jurisdictions have features that could prevent us from granting high ratings on sukuk. For example, a number of jurisdictions in the Middle East raise questions about which parties' obligations would be enforceable in local courts, whether they would recognize contractual governing law (for example, in Saudi Arabia), and whether security would be enforceable. Sometimes uncertainties pertaining to the legal environment surrounding sukuk issuances are simply due to the fact that the relevant legal framework has so far been untested, because the laws have been so new and defaults lacking. Appendix 1: Sukuk Rated By Standard & Poor's Sukuk Rated By Standard & Poor's Rating Services As Of Sept. 17, 2007 ORIGINATOR DATE OF RATING ISSUE AMOUNT (MIL. $) LONG-TERM FOREIGN CURRENCY RATING Central Bank of Bahrain Sukuk Various 1,094 A DIB Sukuk Co. Ltd. Feb. 15, 2007 750 A DP World Sukuk Ltd. (Obligor: DP World) June 27, 2007 1,500 A+ Dubai Sukuk Center Ltd. (Guarantor: DIFC Investment LLC) May 25, 2007 1,250 A+ East Cameron Gas Co. Sukuk July 31, 2006 166 CCC+ EIB Sukuk Company Ltd. Programme (Guarantor: Emirates Bank International) May 15, 2007 1,000 A GFH Sukuk Ltd. (Obligor: Gulf Finance House) June 26, 2007 1,000 BBB- Gold Sukuk dmcc (Guarantor: Dubai Multi Commodities Centre Authority) April 11, 2005 200 A Golden Belt 1 B.S.C. April 18, 2007 650 BBB+ Islamic Development Bank May 20, 2005 1,000 AAA Ithmaar Sukuk Co. Ltd. (Guarantor: Shamil Bank of Bahrain) June 20, 2007 TBD BBB- Loehmann's Capital Corp. (Guarantor: Loehmann's Holdings Inc.) Sept. 22, 2004 110 CCC+ Malaysia Global Sukuk Inc. June 10, 2002 600¶ A- MBB Sukuk Inc. April 11, 2007 300 BBB+ Pakistan International Sukuk Co. Dec. 23, 2004 600 B+ Qatar Global Sukuk QSC Sept. 10, 2003 700 AA- Sarawak Corporate Sukuk Inc. Nov. 30, 2004 350 A- Sharjah Islamic Bank Sukuk Sept. 12, 2006 255 BBB Solidarity Trust Services Ltd. (Guarantor: Islamic Development Bank) Aug. 11, 2003 400 AAA Stichting Sachsen-Anhalt Trust July 9, 2004 100* AA- Tabreed 06 Financing Corp. June 15, 2006 200 BBB- *Euros. ¶Matured. TBD--To be determined. Appendix 2: Related Criteria And Research Structured Finance In The Middle East: Promising Indicators For Development, Aug. 6, 2007 Chief Drivers Behind Islamic Finance's Global Expansion, April 23, 2007 Islamic Finance To Expand Slowly But Surely In The Maghreb, April 23, 2007 Takaful: A New And Viable Insurance Business Model Or Just A Marketing Opportunity? April 5, 2007 World's Islamic Finance Industry To Get A Boost From U.K.'s Development As A Major Marketplace, March 21, 2007 Credit FAQ: An Introduction To Islamic Finance, Nov. 14, 2006 The Islamic Financial Industry Comes Of Age, Oct. 25, 2006 The Meaning Of Ratings For Islamic Financial Institutions, Oct. 25, 2006 Islamic Finance Outlook 2006, September 2006 (brochure) Standard & Poor's Classic Ratings Approach Applies To Islamic Banks Despite Sector Specifics, Aug. 31, 2006 Islamic Banks In Malaysia Less Profitable Than Gulf Counterparts, July 5, 2006 Takaful: A New Face For Insurance, Jan. 31, 2006 Two Aspects Of Rating Sukuk: Sharia Compliance And Transaction Security, Jan. 12, 2006 Enhancing Financial Reporting And Transparency: Keys To The Future Of Islamic Finance, Dec. 14, 2005 Standard & Poor's Looks At Features Of Islamic Banks' Unique Funding Instruments, June 14, 2005 A Closer Look At Ijara Sukuk, Feb. 2, 2005 Islamic Banking: A Unique Differentiation Strategy for Gulf Financial Institutions, Nov. 22, 2004 Rating Sukuk--How Rating Methodologies Apply to Islamic Debt Financing, Sept. 15, 2003 Malaysian Islamic Financing Risks Are Manageable, Sept. 10, 2003