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Analyzing the Creditworthiness of Islamic Financial Institutions

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ABSTRACT

Several issues are involved in analyzing the financial strength of Islamic financial institutions (IFIs). First, is an international rating agency such as Moody's qualified to analyze IFIs? Second, how does the analysis of IFIs differ from that of *ribā*-based banks? Third, based on the analysis, is it possible to say that IFIs are more or less creditworthy, as a class, than *ribā*-based banks? International agencies are qualified to analyze IFIs because the tools for analyzing them are the same as those used for *ribā*-based banks. Differences lie only in the requirement to understand the structure of certain financial instruments and the cultural/ethical agenda of Islamic bankers. Furthermore, it is not possible to say that the Islamic nature of IFIs makes them more or less creditworthy as a class than *ribā*-based banks. In some respects, it makes them stronger than *ribā*-based banks, but in other cases it can make them weaker.

I. INTRODUCTION

Islamic financial institutions (IFIs) are increasingly involved in international financial markets. This process is being driven not only by the desire and ability of IFIs to extend the range of their activities, but also by the appetite of western banks and investors to do business in what are commonly referred to as "emerging markets" where most IFIs are based.[i]

Credit ratings issued by the international credit agencies are an important feature of the international financial landscape. Banks and investors use these ratings to make lending and business decisions. A credit rating, therefore, is significant in determining a financial institution's ability to operate in international financial markets.

The purpose of this paper is to explain how we at Moody's Investors Service—one of those international rating agencies—analyze Islamic Financial Institutions. The paper addresses three main questions:

1. Is an international agency such as Moody's qualified to analyze IFIs?
2. How does our analysis of IFIs differ from our analysis of conventional (*ribā*) banks?
3. Based on that analysis, is it possible to say that IFIs *as a class* are more or less creditworthy than *ribā*-based banks?

This paper takes as a given the role of international rating agencies in the world financial system. Many people have opinions about the influence of international rating agencies, but it is not the purpose of this paper to provide an *apologia* for our activities. The aim is simply to explain how we do our analysis in respect of Islamic financial institutions.

Moody's publishes credit ratings on nearly 1,000 banks worldwide. Bank analysis is only one part of our business, which includes analysis of companies, securities houses, mutual funds, insurance, and structured instruments. We rate Kuwait Finance House, Al Rajhi Banking and Investment Corporation, four banks in Pakistan, which has a wholly-Islamic banking system, and we have ratings on many banks which offer Islamic windows within an overall context of *ribā*-based activity—for example, we rate all the Saudi Arabian banks, most of which offer Islamic windows. So when, for example, we analyze National Commercial Bank in Saudi Arabia, we assess the role which its Islamic business plays in its overall creditworthiness.

II. WHAT DO WE MEAN BY A CREDIT RATING?

This is not the place for a full explanation of Moody's rating methodology. But it is important to be clear about what a rating is, and what it is not. Simply put, a credit rating is an opinion on the likelihood that an institution will be able to re-pay its debts in full and on time. (Of course this immediately raises the question of whether Islamic depositors do actually expect to be paid in full and on time. After all, Islamic banking theory

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requires some classes of depositors to share risk with the bank and to see the value of their deposits reduced if the bank declares a loss. This issue is discussed below.)

When, for example, we assign a rating of Aaa ("triple A") to bonds issued by the German government, or deposits placed with Rabobank, one of the leading Dutch banks, we are saying that there is a very high probability that those bonds, or deposits, will be repaid in full and on time. A country whose bonds are rated lower, or a bank whose deposits are rated lower, has in our opinion a lower probability of being able to discharge those obligations in full and on time.

And that is all a rating is. Our Aaa rating on Rabobank is not a recommendation for people to open accounts there. It does not imply that Rabobank offers the best customer service, has the cleanest, most modern banking halls, or offers the highest rates on savings accounts. It is simply an opinion on its ability to service debt. Clearly many factors go into that opinion—and the quality of customer service, for example, will over the long term have an impact on the standing of the bank—but the only issue *directly* addressed by a rating is creditworthiness.[ii]

A credit rating does not address the issue of stock valuation. An equity analyst will express an opinion on whether a bank's shares are likely to increase or decrease in value. We are credit analysts and look only at the bank's ability to repay debt and deposits. It is interesting to discuss whether, over the long term, there should be a correlation between stock price appreciation and creditworthiness, but that lies well beyond the scope of this paper.

III. Are Our Ratings Relevant to Islamic Institutions?

We noted that many Islamic depositors may not expect to receive their deposits back in full and on time, since in some circumstances they are expected to share losses with the institution holding their money. Nevertheless, when rating Islamic banks, our focus remains unchanged. Simply put, "If you put a dollar with this bank, will you get it back?" For those Muslims who feel that that is an irrelevant question, our bank ratings will indeed have little value. We respect that. However, we would suggest that many people who deposit with an Islamic bank are *in practice* very interested in the answer to that question.

It is sometimes suggested that rating agencies should treat Islamic banks as mutual funds rather than as banks. Investors in mutual funds accept that the fund manager has no obligation to repay the sum originally invested, although he does have an obligation to return that sum plus or minus any gains or losses incurred: the obligation lies in liquidity not on a specific return on investment. Moody's mutual fund ratings measure that liquidity and not specific return, so would mutual fund ratings not be a more appropriate method of rating Islamic banks?[iii]

Our response again addresses the practicalities of depositors' expectations. Muslim depositors have the opportunity to invest in *sharīʿa*-compliant mutual funds and many do. Yet substantial funds are also placed with Islamic banks, implying that depositors are making a distinction between the two types of institutions. We believe that if an Islamic bank were to require depositors to take a loss, and this was portrayed as an ongoing, albeit exceptional, risk which depositors would have to face, then the bank would cease to be a going concern—it would suffer a run on deposits. Investors in mutual funds accept the possibility of negative asset values and even real losses on encashment. Bank depositors expect a greater degree of security.

The analysis contained in the preceding paragraphs is far from being complete. There is a need for more work on the subject of Islamic banks and mutual funds. Perhaps one way into such work is to look at the "constant net asset value" money market funds in the U.S., in which investors do not expect to see their original investment/deposit written down below par, even though they are aware that their money is being invested in a fund. In cases where the net asset value has indeed fallen below par, parent banks and guarantors have stepped in to make up the difference.

IV. A Credit Rating Does Not Take a View on What Is *H̲arām* or *H̲alāl*

We at Moody's do not take a view on what does or does not constitute Islamic finance. It is no part of our analysis to opine on whether an IFI conforms to the *sharīʿa*, or whether a certain Islamic instrument—*murābah̲a* for example—is *h̲arām* or *h̲alāl*. Nor would we take a view on whether the way in which a certain instrument is employed in a specific situation is *h̲arām* or *h̲alāl*. Firstly, we are not qualified to do that—we are credit analysts not Islamic scholars. Secondly, it is for Muslims to define and shape Islamic finance according to their beliefs and requirements. We do have opinions on what would make banks more creditworthy—that is our business, but we do not have opinions on what would make them more "Islamic"—that is the business of Muslim scholars.

We do however take an interest in whether an IFI is perceived *by other Muslims* as being compliant with the *sharīʿa*. Suppose an IFI were to get a reputation for investing clients' funds in areas which were subject to some

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doubt over *sharīᶜa* compatibility. This could result in depositors withdrawing their savings from that bank and placing them in another bank that had a reputation for more stringent *sharīᶜa* compliance. If the loss of deposits was large, the bank might come under severe strain, and have difficulty repaying deposits when due. As a result, its creditworthiness would be impaired. Conversely, the bank that had a reputation for stringently applying *sharīᶜa* rules would have little difficulty attracting deposits from Muslims, a fact that would strengthen its balance sheet and so enhance its creditworthiness.

V. Are We Qualified to Analyze Islamic Financial Institutions?

We believe that we are qualified to express opinions on the creditworthiness of IFIs. We recognize that specialized knowledge and understanding is needed in order to do that analysis, but the process of acquiring that knowledge and understanding is no different from the process required to analyze banking systems throughout the world. For example, Brazilian banks cannot be understood unless the analyst appreciates the effects of hyperinflation on a banking system. Chinese banks cannot be understood unless the analyst appreciates the bureaucratic culture, which still pervades much of China and the difficulties of economic management in such a vast land.

Or take another example: ten years ago, analysts looking at U.S. banks did not have to spend much time getting to grips with complex financial instruments such as derivatives—because the derivative industry was in its infancy. But now, anyone analyzing a U.S. bank must be able to appreciate not only how those instruments work, but also why a bank uses them and the impact that they have on its creditworthiness. In our opinion, the process of understanding the mechanics and the uses of new financial instruments such as derivatives is similar to the process which an analyst new to Islamic banking would go through to understand a *murābaẖa* transaction or any other Islamic financial instrument.[iv]

For an outsider, understanding Islamic banking is a question both of getting to grips with the mechanics of how Islamic financial instruments work, and, equally importantly, understanding the religious sentiment which lies behind them. The acquisition of this knowledge and understanding is not beyond the capacity of an intelligent and open-minded analyst. At the risk of sounding flippant, we believe that you do not need to be a socialist in order to analyze a cooperative bank. You have to respect its individuality and how it differs from other banks, but you don't need to be part of the cooperative movement yourself.

VI. How Does Our Analysis of IFIs Differ from That of *Ribā*-based Banks?

The process and methodology of bank analysis is the same for banks world-wide, but the specific issues driving their creditworthiness may differ from place to place and time to time. This is not a question of Islamic banks versus *ribā*-banks, or developed market banks versus emerging market banks. Even within so-called developed banking markets, issues driving creditworthiness may differ widely. We recognize and respect the individuality and diversity of all banks and banking systems in the world, including Islamic banks.

We would suggest that the key features of an IFI that a western analyst must recognize are the following:

Islamic banks see themselves as having a social responsibility and therefore are not as profit-orientated as *ribā*-based banks. For example, many *ribā*-based banks deliberately eschew customers who keep low deposit balances or do not conduct a high volume of transactions, since these customers are not particularly profitable to the bank. Islamic banks do not behave like that, because part of their business ethic is to offer banking services to whoever needs them.

Some financial instruments used by IFIs are different from those used in *ribā*-based banks—for example, *murābaẖa*. The analyst needs to understand the structure of these instruments and their accounting treatment.

Islamic finance takes a different approach to capital. Islamic financial theory does not draw such a strong distinction between deposits and capital, as do *ribā*-based banks. Islamic banks sometimes argue that their capital is protected by the fact that depositors share losses alongside shareholders. In contrast, the capital of a *ribā*-bank must absorb the full force of losses, with deposits being compromised only after capital funds have been exhausted. Indeed, this would lead some Islamic bankers to reject the western concept of capital as the cushion against loss. This is a complex and difficult issue, and one where there is a huge difference between theory and practice. Nevertheless, for a credit analyst, the notion that the claims of depositors might be treated on a par with the claims of shareholders is a very important issue.[v]

IFIs manage their liquidity differently from *ribā*-based banks, because they cannot use the international interbank market—the market through which *ribā*-banks borrow or place money short-term. It is important to note that "different" liquidity management does not mean "worse." IFIs are conscious of the need for adequate liquidity

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and that they must therefore develop alternative sources of short-term funding. The job of the analyst is to understand these alternative sources and then make a judgment.

Islamic finance is still an industry in formation. There is considerable discussion within the industry about what is or is not an acceptable Islamic instrument or an acceptable accounting methodology. (Though we should recognize the important work being done by AAOIFI to define and have accepted standard accounting procedures.) This introduces an element of uncertainty into the operations of Islamic banks. Questions such as the validity of subordination of claims, or the liability of fund managers to make good initial investment values, are vital in assessing the creditworthiness of financial institutions. Yet issues such as these are often subject to divergent opinions and lack of precedent.

IFIs are sometimes subject to different regulatory regimes from *ribā*-based banks operating in the same market. This is not always so, but sometimes the prudential ratios imposed by banking supervisors differ between Islamic and *ribā*-based institutions. (Kuwait is an example).

It is worth highlighting one important way in which Islamic banks are *not* different from *ribā*-based banks, even though they may appear to be. In theory, the returns which Islamic banks give to their depositors reflect the overall level of profitability of the bank. So if the bank has a particularly good year, one would expect to see deposit rates being particularly high, and if the bank has a difficult year, they would be low. This does not happen in practice. That is a fact, and one can look at the annual reports of Islamic banks to see how much they pay to depositors and it is about the same as the *ribā*-banks in the same systems are paying. Even in wholly Islamic systems, such as Pakistan, returns to depositors are in line with what macro-economic fundamentals and the economic priorities of the Pakistani government would suggest, rather than what the performance of the banking system would suggest. The point is that if Islamic banks were to pay their depositors below-market rates of return in a difficult year some of those depositors would leave the bank and go elsewhere. So Islamic banks have to keep up with market rates of return—which are driven by events in the *ribā*-based economy.

VII. Conclusion

There are some elements of Islamic finance which make IFIs more creditworthy than *ribā*-based banks and other elements that make them less creditworthy. But we do not believe that IFIs are *inherently* more or less creditworthy than *ribā*-based institutions. Put another way, we do not believe that it is possible to say that IFIs *in their capacity as IFIs* are more or less creditworthy than *ribā*-based banks.

On one side, it is often the case that Islamic banks have a lower cost of funds than *ribā*-based banks because many of their deposits are *qard-hassan* and so free to the bank. This often translates into higher profitability—and strong profitability is an important element in being creditworthy.

IFIs can often count on strong customer loyalty. In countries where Islamic and *ribā*-based institutions operate side by side, those who use IFIs often do so because they feel a religious obligation. If they have a problem with their bank—for example, a mix-up with a financial transfer, or a bank statement that does not arrive on time—they are not going to close their account and go to the *ribā*-based bank down the road. That sort of customer loyalty is a big advantage to a bank, and improves its creditworthiness.

The asset structures of Islamic banks tend to be shorter-term than those of *ribā*-based banks and this would generally imply that they are less subject to risk. On the other hand, we think that some of their assets are less liquid than those of *ribā*-based banks—because they have less access to a deep secondary market—and that would imply greater risk. This is quite a difficult issue, and one that really has to be considered on a bank-by-bank basis.

One area where we do have concern with IFIs is that of internal controls. There have been some cases in recent years of IFIs suffering losses due to poor controls and in our observation of IFIs we see this as an area where they are sometimes less strong than *ribā*-based banks. There is no reason why IFIs *in their capacity as IFIs* should not have equally sound controls. But it turns out that, in our opinion, they often do not, and clearly that is an important point to consider when assessing their creditworthiness.

In conclusion, one returns to the issue of Islamic finance being an industry in development. Moody's ratings are forward looking—we are asking whether an IFI will be creditworthy some years from today. It is easier to be sure of creditworthiness some years down the road when you know that an institution is operating within clearly established precedents—within accepted "rules of the game" which are unlikely to change very much. The lack of that certainty is an important consideration to us. We would not want to over-dramatize this issue, but it is appropriate to highlight it in this paper, since accounting, regulation, and the structure of new instruments are subjects that are of direct relevance to this conference. We believe that in time these uncertainties will be removed, in part through the deliberations at conferences such as this one, and that as a consequence the creditworthiness—and ratings—of IFIs will become stronger.

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[i] In this paper, the terms IFI and Islamic bank are both used. IFI refers not only to banks, but also to the full range of Islamic financial institutions. However, in many instances the text is in practice referring to those IFIs that call themselves banks, and so they are called as such.

[ii] Moody's assigns two types of ratings to banks: bond/deposit ratings and financial strength ratings (FSRs). Bond/deposit ratings measure repayment ability, which is the issue under discussion here. FSRs are a subset of bond/deposit ratings and look only at a bank's intrinsic financial strength.

[iii] Moody's also assigns ratings to mutual funds, which assess their likely volatility.

[iv] Note that the point is to draw equivalence between the learning processes involved, not to argue that Islamic financial instruments *are* derivatives.

[v] An interesting related question is whether the claims of depositors and shareholders would be treated *pari passu*. Shareholders would normally expect the return generated on their dividends to exceed the return paid on deposits, and, in western financial markets, that would imply that they would be expected to bear greater losses. There is the further question of whether the *sharīᶜa* would recognize differing priority of claim among different types of deposits.

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