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CONVENTIONAL AND ISLAMIC BANKS' RISKS: RATING ASSESSMENT FROM CREDIT RATING AGENCIES

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ABSTRACT

Similar to conventional banks, Islamic banks perform all those functions expected from a financial institution and assist the business world by providing all the services required to run an economy smoothly. However, the philosophy and operational methods of Islamic and conventional banks are different. Their different philosophies have resulted in Islamic banks confronted and deal with risks that are akin to those conventional financial institutions and risk that exclusively stemming from *Shariah* (Islamic law) implications. This study will examine the methodology used by different various credit rating agencies in assessing various risks of concerning conventional and Islamic banks operations. Since the operations of Islamic financial institutions must be consistent with *Shariah*, this paper will also examine to what extent *Shariah* issues are factored into rating methodology when evaluating the creditworthiness of Islamic banks. The research on ratings will helps help boost investor confidence in the Islamic finance industry and also enhances enhance our understanding of the concept despite the different methods adopted by the agencies concerned.

KEYWORDS: Conventional Banks, Islamic Banks, Rating Methodology, Risk, *Shariah*

INTRODUCTION

From humble beginnings in a small village in Egypt in the late 1960s, Islamic banks have now spread too many countries around the world. The number of Islamic banking institutions rose from 75 in 1975 to over 300 in 2005, in more than 75 countries (El Qorchi, 2005). The industry has emerged strongly to position itself as an alternative to conventional finance, with products that are claimed to be more sustainable and equitable. 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 as Islamic banks being confronted with risks that are akin to those conventional financial institutions and risks that exclusively stem from *Shariah* (Islamic law) implications. Given the 'unique' risks embedded in Islamic bank operations coupled with their remarkable development, this 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. Therefore, this study will examine 'how' different risks embedded in Islamic as compared to conventional bank operations are evaluated by different credit rating agencies. The rating methodology use by various credit rating agencies in determining credit strength of Islamic banks will be investigated. In addition, to what extent *Shariah* issues are factored into rating methodology when evaluating the creditworthiness of Islamic banks will be considered.

This paper starts with a review of previous studies on Islamic banks, followed by an outline of the methodology used here. Then this paper discusses the different risks encountered by Islamic banks compared to conventional banks. Rating methodologies employed by various international credit rating agencies for determining the credit strength of conventional banks will be explained. The extent to which credit rating agencies differ in evaluating conventional and Islamic banks will be examined, including an assessment of *Shariah* compliance in their rating methodology.

LITERATURE REVIEW

Over the past few decades, the Islamic finance industry has rapidly expanded worldwide. While it is difficult to identify precisely the date when the first formal Islamic financial institution began operating, 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 to be worth approximately US$2 trillion, covering bank and non-bank financial institutions, capital markets, money markets and *takaful* (insurance) (The World Bank, 2015). In fact, the growth of the Islamic banking system has been 50% faster than the overall banking sector (Ernst and Young, 2012). 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. The operations and financial innovations of Islamic finance often bring about changes in the perception of risk (El-Hawary, Grais, & Iqbal, 2004). As such, the premise of Islamic banks' risks as opposed to conventional banks' risks has been widely discussed in the Islamic finance literature. The philosophy and operations of Islamic financial institutions has been explained by scholars such as Ahmed (2011), Hassan and Mahlknecht (2011), Hassan and Lewis (2007), El-Gamal (2000). While other studies such as Hanif (2011) and Beck, Demirgüç-Kunt, and Merrouche (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 (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. Doing so will enable investors or shareholders to be better informed about their investment risk (Faheem, 2000).

In determining financial institutions' ability to operate in international financial markets, regardless of whether they are Islamic or conventional banks, credit ratings issued by the international credit agencies are an important feature of the international financial landscape. This is because banks and investors use these ratings to make lending and business decisions. In fact, throughout the world, their ratings are one of the main concerns of sovereign governments, municipal authorities, banks, and non-financial companies. Their determinations of the risk presented by loans to or investments in bonds of corporations, countries, states, municipalities and other public agencies is a major factor in the ability of these entities to raise funds and to a great extent establishes the rate of interest they must pay to obtain credit. With regard to credit rating agencies' methodology, many previous studies concentrate on predicting the bond rating assigned by credit rating agencies using various statistical analyses. For example Horrigan (1966), West (1970) and Kim and Gu (2004) have used ordinary least squares (OLS) analysis, while Altman (1968), Morris (1982), Huffman and Ward (1996) have used Multiple Discriminant Analysis (MDA) in order to capture and model the expertise of the bond rating process. Similar studies, Kaplan and Urwitz (1979), Ogden (1987) and Gentry, Newbold, and Whitford (1988) used Probit analysis to predict bond rating. Taking into account the important role of credit agencies, many studies such as those by Radelet and

Sachs (1998); Sinclair (2003) and Nada (2006), have observed credit rating agencies were undoubtedly laggard and procyclical during the 1997-98 Asian Financial Crisis. In fact, they failed to predict mega-bankruptcies such as those that devastated Enron, WorldCom, Parmalat (Frost, 2006; Rom, 2009; White, 2010) and Lehman Brothers (Liu, Jones, Walton, & Gu, 2011). While conventional bond and financial institutions and credit rating methodology have received considerable attention in the finance and investment literature, credit rating processes and methodologies as they apply to Islamic financial institutions have to date remained largely unexplored.

METHODOLOGY

The scope of this research is limited to theoretical contexts with secondary source data from relevant studies, in order to achieve the stated objectives. Data collection will be taken mainly from formal publications from credit rating agencies, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and Islamic Capital Market, Securities Commission, Malaysia and various Islamic banks' reports. According to Elkhoury (2008) the processes and methods used to establish credit ratings vary widely among credit rating agencies. Therefore, in considering the rating methodology of credit rating agencies for Islamic banks, this research will focus on international credit rating agencies, in particular Standard & Poor's, Moody's and Fitch. Additionally, accounting for Malaysia as the world's largest issuer of *sukuk* (Islamic bonds), the rating methodology of Islamic banks by Rating Agency Malaysia (RAM) and Malaysia Rating Corporation Berhad (MARC) were also considered in this study.

How different are Islamic Banks' Risks from those of Conventional Banks?

Since this paper concentrates on 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 both types of banks operate. While the Islamic banking system is based on the Islamic faith and must stay within the limits of Islamic law or *Shariah* in all of its actions and deeds, the functions and operating modes of conventional banks are based on fully man-made or secular principles. As far as *Shariah* 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 *Shariah*-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 how Islamic and conventional banks organize and implement their funding and activity structures (Ariff, 1998). Hence, based on 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 is exposed.

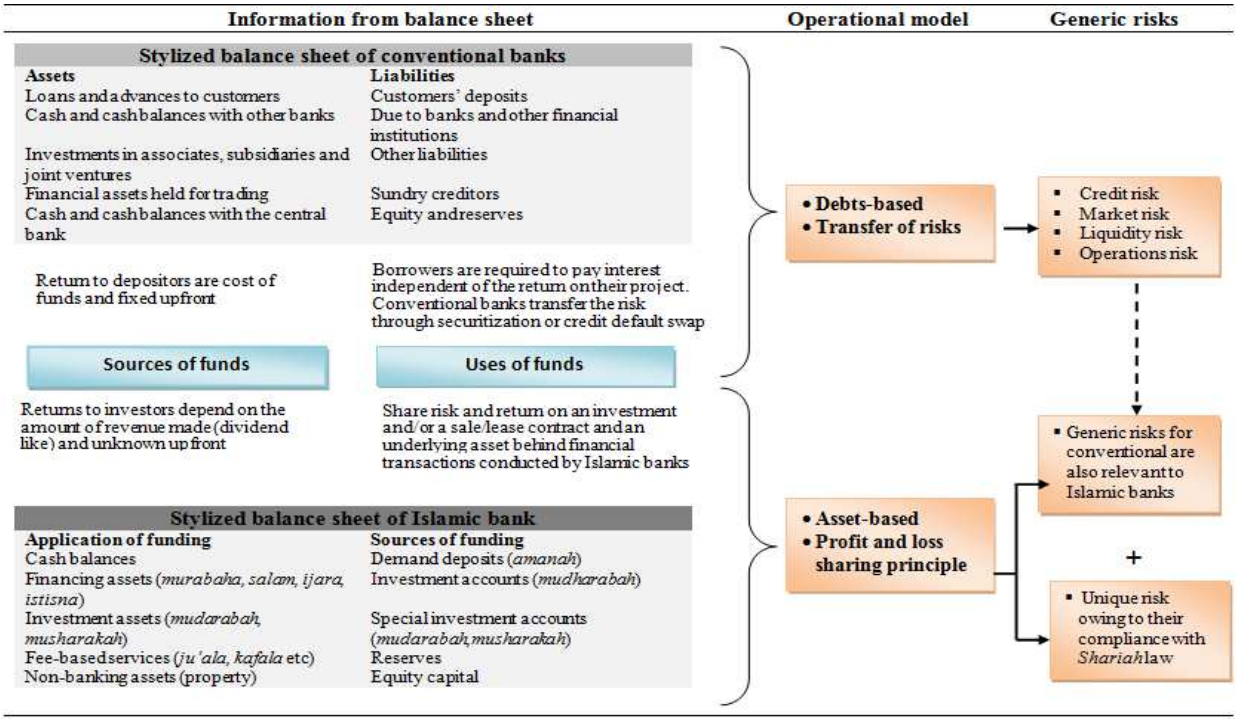

Figure 1: Overview of Conventional and Islamic Banks' Different Types of Operations and Risks

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 risk, market risks and operational risks (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 greatest 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.

Further, 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).

Risk 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 take 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 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 *murabahah*), *bai-muajjal* (price-deferred sale), *istisnaa/salam* (object deferred sale or pre-paid sale) and *ijarah* (leasing) and profit-sharing modes of financing (*musharakah* and *mudharabah*) (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. In this regard, Islamic banking will have extra protection, for instance in the form of *mudharabah* saving and investment (S&I) deposits. It is based on the profit and loss sharing contract between Islamic banks and account holders. Because of this quasi equity, a priori, Islamic banking is expected to take less risk 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 show 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 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 conventional ones (Greuning & Iqbal, 2008; Iqbal & Mirakhor, 2007). As noted earlier, one of the prominent features of Islamic finance is that it must conform 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 Islamic banks' accountability being seriously compromised (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 access to *Shariah*-compatible money market and intra-bank market is limited. Third, the lender of last resort (LLR) provides an emergency liquidity facility to banks whenever it is needed. The existing LLR facilities are based on interest and therefore

Islamic banks cannot benefit from these transactions (Ahmed & Khan, 2007p.145). With this in mind, Islamic banks may face 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 encountering 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, a 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 in some sense, account for its superiority over conventional banking on the grounds of ethics and efficiency. However, there is a strong probability that an equity investment risk in Islamic banking on the asset side may arise. This equity investment risk develops 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.

Further, Islamic banks are also exposed to displaced commercial risk. The 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 dissuades 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 *Shariah* compatible short-term securities in most Islamic jurisdictions to hedge against foreign exchange risk or in case of liquidity risk management may result in problems arising when market risks have to manage. Given the challenges in risk management of Islamic banking compared to the conventional banking system, it can be argued that credit rating agencies serve a more important function compared to conventional banking. It is not only in identifying, measuring and monitoring risks, but also in distilling the complexity of these risks and communicating these risks to the general public besides the market participants (Leng & Othman, 2014). The challenges and 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, including to what extent *Shariah* assessment has been factored into their rating methodology?

Rating Approach for Conventional Banks[1]: 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 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.

[1] 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

	Conventional Banks		Islamic Banks
Credit Rating Agencies	**Standalone Credit Profile**	**External Support**	**Different Ratings to Address Categories of Islamic Banks**
Standard and Poor's (Standard & Poor's, 2006)	▪ Banking Industry Country Risk Assessment (BICRA) methodology - macro factors - bank-specific factors	Extraordinary support by government or group	Applies the same analytical framework to IFIs as it does to any non-Islamic bank.
Moody's (Howladar & Chen, 2014)	▪ Baseline Credit Assessment (BCA) - macro profile - financial profile - qualitative adjustments	Support and structural analysis a. affiliate support b. loss given failure c. government support	Approach to rating Islamic Financial Institutions (IFIs) does not differ from that used to rate other financial institutions.
Fitch (Fitch, 2007)	▪ Viability rating - Operating Environment - Company Profile - Management and Strategy - Risk Appetite - Financial Profile	Support rating	Fitch believes that its current rating methodologies and rating scales can continue to accommodate *sukuk* and Islamic banks.
RAM (RAM, 2008).	▪ CAMEL framework (Capital, Asset Quality, Management, Earnings and Liquidity) ▪ Total Risk Assessment (TORA)	Systemic support	The assessment of the IFI's management team would, however, include an evaluation of the *Shariah* approval process for the products and services of the in house/ external *Shariah* advisory panel.
MARC(MARC, 2012)	▪ Stand-alone analyses	Consolidated group analysis	Employs CAMELS framework with some modifications due to a unique approach in rating IFIs.

Sources: respective credit rating agencies' websites

In assessing banks' creditworthiness, generally credit rating agencies have established their own analytical frameworks. Regardless of any 'name' designated to the analytical framework, their stand-alone analysis incorporates both quantitative and qualitative analysis and classic drivers of 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 plays 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 to determine extraordinary external support is conducted in two ways: the first is support from the 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 in generally focus on direct benefaction to an individual bank in providing liquidity or capital injections, or by buying or insuring risky assets. In the meantime, also examined is to what extent government interference via ownership or regulation can influence a bank's business decisions.

Building on the stand-alone credit assessment that is computed combining the macro environment 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.

Rating Approach of Islamic Banks: International Credit Rating Agencies versus RAM and MARC

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 *Shariah*, 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 helps explain the clear differences in funding and activity structures of Islamic and conventional banks. However, this is not the case from the perspective of 'three big international' credit rating agencies in assessing the credit strength of Islamic banks (see Table 1). They do not differentiate them sufficiently enough from conventional banks when requesting a credit rating. In general, Standards & Poor's, Moody's and Fitch use the same basic conventional principles, set of criteria, analytical framework and rating methodology when assessing Islamic banks. Each agency believes that its criteria and methodology to generate 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. The analytical framework used is the same including examining it's financing and lending policy, risk diversification practice and general management prudence.

While international credit rating agencies assess the risk profile of an Islamic bank in the same way they look at conventional banks, RAM and MARC have provided different risk perspectives in assessing Islamic banks' creditworthiness. RAM takes into account the unique features of Islamic banks, i.e. interest-free loans and relevant *Shariah* codes that apply to Islamic financial institution, in supporting the conventional analytical framework of Total Risk Assessment (TORA) and CAMEL (RAM, 2008). 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 necessity is to analyze the composition of the underlying asset portfolio – *mudharabah*, *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 *Shariah* framework and considers adequacy of processes, practices and procedures for *Shariah* compliance as well as compliance with laws and regulations (MARC, 2012).

In general, the 'unique' risks 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.

The *Shariah* Assessment Factor in Rating Methodology

In the context of *Shariah* compliance, there is no single component in the rating approach by the international 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 maintained 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 financial obligations in a timely manner, without commenting on *Shariah* compliance. This means *Shariah* compliance is not featured in any of Standard and Poor's rating analysis (Al-Amine, 2008) and this applies also 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 claimed 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).

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 AAOIFI and the Islamic Financial Services Board (or IFSB), where applicable. While MARC has appointed its own *Shariah* Advisory Panel to advise on *Shariah* matters of Islamic financial institutions and review new or variations to Islamic rating products and rating definitions so that they are compatible with *Shariah* requirements.

Although RAM and MARC have added *Shariah* 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. While Islamic finance industry currently has the Islamic International Rating Agency (IIRA) to provide a rating spectrum that encompasses the full array of capital instruments and specialized Islamic financial products, however, it will not be possible for it to rate the thousands of counterparties with whom banks deal (Chapra, 2007; Chapra & Ahmed, 2002). This premise 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.

CONCLUSIONS

As 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. In this regard, the Islamic rating approach needs to be refined in order to achieve results similar to the ones noted for the conventional financial system by accommodating the unique features of Islamic banks. Islamic banks should look 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. The Islamic bank rating system is expected to benefit from 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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