



RATING METHODOLOGIES

Sukuk

2024 – Public Version

INTRODUCTION

This Methodology provides SIMAH Rating Agency (TASSNIEF)'s general approach to *Sukuk* Rating. As in the Conventional Bonds, *Sukuk* may be issued on a short-term, medium-term or long-term note, depending on the needs of the issuance and subject to the contract used, these instruments incorporate either fixed or floating-rate profit margins.

Sukuk may be structured from one or a combination of several Islamic contracts, thus the rights, obligations, and consequences of the non-fulfillment of these instruments rest on the nature of the Islamic contract or contracts that underpin the whole transaction.

Generally most *Sukuk* are based on bilateral contracts, commonly using the contracts of exchange, utilization of usufruct or partnership contracts. Predominant form of exchange contract in *Sukuk* is *Murabahah* while *Ijarah*, a usufruct-based contract is also preferred. Partnership contracts namely *Mudharabah* or *Musharakah* are quite common in some jurisdictions.

TASSNIEF'S RATING APPROACH

Sukuk can be formed using a single contract or a mixture of several Islamic contracts. However, a common feature in all *Sukuk* structures is the existence of the asset at their core, in line with the Shariah principle that requires economy activities to be reflected in any transaction.

Asset-based *Sukuk* represent a beneficial interest in or claim on the underlying asset, however, the credit implications of these asset-based *Sukuk* may not be equivalent to those of asset-backed if the transaction terms do not denote a secured claim on the underlying asset. The credit risk of asset-based *Sukuk* is not tied to the performance of the underlying asset but is instead linked to the issuer's creditworthiness.

TASSNIEF'S approach to *Sukuk* rating is based on three broad frameworks:

1. Corporate or financial institutions Rating Methodology

TASSNIEF will apply the rating methodology for Corporates or financial institutions if the underlying obligor for the *Sukuk* is a corporate or financial institution. In this case, the credit quality of the obligor will be the key driver of the *Sukuk* credit risk, and the final assigned rating will depend on the ranking of the *Sukuk*, relative to the obligor's existing senior unsecured obligation and based on the notching policy adopted by TASSNIEF.

2. Project Finance Rating Methodology

For *Sukuk* transactions with the project-finance characteristics where key project risks are addressed through contracts and covenants, TASSNIEF uses the project finance methodology in assessing the respective *Sukuk*. The assessment of the *Sukuk*'s credit risk essentially reflects the ability of the underlying project asset to generate sufficient cash flow to meet the *Sukuk* obligations

3. Asset-backed or Structured-finance Methodology

The asset-backed or structured finance rating methodologies will be applied if the *Sukuk* transaction encompasses the securitization elements whereby the credit risk of the *Sukuk* is de-linked from that of the asset originator and determined solely by the performance of the underlying assets. The assessment includes the capacity of the managing agent to act as servicer

and to transfer payment from the obligors to the *Sukuk* holders. The exercise also looks at the expected value of the reinvested cashflows, in comparison to the principal amount.

All these assessments and analyses are done based on the behavior modelling of the underlying mortgages and liquid instruments under various possible stress scenarios and on the assumptions of the recovery rates of the securitized asset classes.

The supportiveness of the underlying legal and regulatory framework, especially on the isolation of the assets from the Originator's insolvency is also examined.

GENERAL RATING GUIDELINES FOR *SUKUK* – THE ANALYTICAL COMPONENTS

1. Analysis of the basic structure

TASSNIEF will initially identify the obligor type of the *Sukuk* to determine the framework and Methodology that will be used to rate the *Sukuk*. As explained in the above approach, if the obligor of the *Sukuk* is a corporate or financial institutions, TASSNIEF will assign the ratings according to their respective credit profiles, using the relevant sector specific methodology.

If the *Sukuk* are structured as a no recourse project finance *Sukuk*, the rating of such *Sukuk* would be fundamentally driven by the quality of the project.

Whereas asset-backed or structured finance methodologies would then be applied if the instrument is structured as an asset-backed transaction. The final rating will reflect the performance of the securitized assets, structural features of the transaction like subordination provided by the different tranches within the same *Sukuk* program, and credit enhancement, if any.

2. Assessment of key transaction parties

In assessing the key transaction parties, while looking at the roles of key participants in the transaction and their abilities to perform their roles, TASSNIEF also looks at the credit quality of each participant and the implication of such risk profile on the *Sukuk*. A shadow rating may be performed on these key participants if their credit quality is regarded as an important driver to the rating of the *Sukuk*.

Key transaction parties include the originator/borrower, lessee(s) or obligor(s), guarantor(s), contractor as well as servicer/back-up servicer and this list is not exhaustive.

3. Assets and cash flow analysis

In assigning ratings to asset-backed or non-recourse or limited recourse project finance *Sukuk*, asset and cash flow analysis is very important. In some cases, *Sukuk* are structured with external liquidity support to mitigate interim deficiencies in returns from the assets. Sometimes, the originator may have a direct or irrevocable obligation to make up any deficiency in the cash flow as in existing 'asset-based' *Sukuk*.

The valuation of the assets also forms an important part of TASSNIEF'S review if the redemption of the *Sukuk* is to be partially or wholly derived from the disposal or refinancing of the assets to the third parties.

If the *Sukuk* are structured to achieve a flow-through during their tenor in the market, TASSNIEF'S analysis will focus on that entity's business and financial risk profiles which are a function of its operating environment, industry trends, market position and size, credit metrics and financial policies, among other analytical factors.

4. Assessment of credit enhancement

In addition to external credit support that may be provided by the originator or third party – the guarantor(s), TASSNIEF will also assess the internal credit enhancements such as reserve accounts, payment waterfalls and the collateral values

5. Legal Analysis

In the context of any securitization, the perfection of legal interest and the insulation of the underlying assets from insolvency are important. There are some *Sukuk* issued with terms that specify certain "trigger event", of which the occurrence of the trigger event would lead to the winding down of the transaction. An example of a trigger event is the failure of the lessee to make required lease payments under an *Ijarah* structure or certain events of insolvency and default connected with the lessee. For *Sukuk* involving an SPV, TASSNIEF considers the bankruptcy remoteness of the SPV and the limitations on its business activities.

6. Pre-Determined Amounts

TASSNIEF uses the conventional corporate debt, project finance or structured rating methodologies for all the fixed-income *Sukuk* that come with pre-determined periodic distribution and redemption amounts. Based on the above features, there is no fundamental differences in the rating approach for *Sukuk* or conventional bonds.

OTHER PRINCIPLES APPLICABLE TO SUKUK RATINGS

1. Priority ranking of obligations

Sukuk should be treated as other unsecured financial obligation and made indistinguishable in terms of payment priority. In this case, the rating of the *Sukuk* will take on the obligor's corporate credit rating.

However, if the *Sukuk* are structured akin to those of a secured structure, with priority claim over the obligor's securitized assets, a comprehensive analysis of the collateral and the lenders' security position will be conducted. The analysis will focus on the nature of the security, the potential of the collateral assets to retain value over time, their liquidity characteristics and the dependence on the company's business conditions.

The *Sukuk* rating may be notched up and rated above the obligor's corporate credit rating but, if the recovery prospects of the *Sukuk* are notably inferior to those of the obligor's other debts, the *Sukuk* rating is likely to be notched down from the obligor's corporate credit rating.

2. Shariah Compliance

TASSNIEF'S *Sukuk* rating process does not cover an analysis of the Shariah compliance risk or the appropriateness of the issue's underlying Shariah concept. All *Sukuk* to be rated by TASSNIEF would have already obtained the Shariah approval from the issuer's Internal Shariah Committee or other authorities that may provide such approvals. TASSNIEF'S *Sukuk* ratings principally focus

on the credit aspects of the transaction, which is in line with its role to provide the market with independent and objective opinions on the credit quality of the issuers or issues.

In general, TASSNIEF does not:

- a. Evaluate or verify the legitimacy and soundness of the *Shariah* committee's recommendations or decisions,
- b. Comment on the degree of *Shariah* compliance. The credit opinions provided are therefore not a measure of the transaction's adherence to Islamic laws as this is under the purview of *Shariah* committee or scholars.
- c. Assess the role, formation, structure, or practices of the *Shariah* committee.

However, TASSNIEF'S analytical tasks relating to *Sukuk* transactions include examinations of *Shariah*-related issues which are necessary to appreciate the contractual terms, operations and mechanisms of the underlying contract(s) supporting the *Sukuk* transaction. The examination also helps to identify *Shariah*-related matters that may have a bearing on the credit risk profile of the *Sukuk*. In this regard, the assessment on the *Shariah*-related aspects and contracts forms an added assessment factor to TASSNIEF'S analytical framework for *Sukuk* rating.

RATINGS METHODOLOGY

Sukuk

No statement in this paper is to be construed as a recommendation
To buy, sell or hold securities, or as investment advice, as it does not
Comment on the security's market price or suitability for any particular investor.

While every effort has been made to incorporate the salient points of
TASSNIEF's experience in relation to the methodology, we note that
The information contained could be updated and altered depending
On changes in our internal views, market conditions, accounting
Practices and regulations.

The methodology is also based on factors
Relevant to the Kingdom of Saudi Arabia and may require adaptation to local conditions.

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