Methodology
Sukuk Rating

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Summary

This methodology describes PACRA's approach to rating the two types of Sukuk: asset-based (also known as "issuer-backed) Sukuk and asset-backed Sukuk. The methodology highlights the difference between the two types and addresses their separate rating criteria.

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0. Introduction

- Debt instrument market
- Key types of debt instruments
- Sukuk rating
- Sukuk structure

Introduction

0.1 Debt instrument market: Pakistan has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing capital markets to raise funding through issuing debt instruments like bonds. Therefore, when instruments are issued, they are plain-vanilla and secured by the assets of the company. Retail investors have also been tapped but generally the instruments are the domain of institutional investors – banks, mutual funds, and retirement benefit schemes. Instrument denominations and tenor also remain on the lower side. Given relatively small base and held to maturity stance of most investors, secondary market is yet to evolve in a meaningful platform.

0.2 Key Types of Debt Instruments: Key types of debt instruments are: term finance certificates (TFCs), commercial papers and Sukuk. These can be differentiated on the basis of: (i) maturity (money market vs. capital market debt instruments), (ii) issuing entities (government, financial institutions, corporates, etc.), (iii) markets in which they are issued (conventional vs. Islamic), (iv) accessibility (listed vs. privately-placed), and (v) security (secured, unsecured or subordinated). PACRA has evolved separate methodologies to cater to the distinct features of structured debt instruments, Sukuk, Basel III Compliant debt instruments and preference shares.

Debt instruments	• Securities with underlying contractual obligation owed by the issuer to make interest payments and principal repayments to the debt instrument holders (or "lenders") for the life of the debt instrument.
Structured debt instruments	• Debt instruments designed to cater to complex financing needs through securitization.
Sukuk	• Islamic debt instruments also referred to as "Shariah-compliant bonds".
Basel III compliant debt instruments	• Debt instruments issued by banks to enhance capital adequacy, based on regulatory requirement prescribed by the State Bank of Pakistan.
Preference shares	• Hybrid instruments sharing both debt and equity characteristics, with fixed-rate dividend and principal redemption agreement.

0.3 Sukuk (plural of sakk – legal instrument), frequently referred as "Islamic bonds", are certificates with each sakk representing a proportional undivided ownership right in tangible assets or business venture (Accounting and Auditing Organization for Islamic Financial Institutions - AAOIFI). Sukuk may take any mode of financing – Musharaka, Modarabah, Murabaha, Waqala, Salam, Istisna, Ijarah.

0.4 Sukuk Rating: Sukuk rating is an opinion on relative creditworthiness of an instrument to fulfil committed obligations. The credit risk to Sukuk holders is that the promise to honor financial obligations that, inter alia, includes rentals, profit sharing, buying back the assets, as and when due, may not be fulfilled. Sukuk rating has benefits for both investor and issuer. For investor, rating quantifies the risk of timely honoring of financial risk relative to other Sukuks. For issuer, Sukuk rating has multitude of benefits: i) it supports pricing or assessment of required returns, ii) it increases accessibility to capital markets, and iii) increases confidence of investors. In many jurisdictions, Sukuk rating has been made mandatory.

0.5 Sukuk Structure: From rating and risk perspective, the underlying structure of Sukuk is important. Sukuk are either asset-based or asset-backed. Rating criteria differs for each type of Sukuk. The following framework helps ascertain which criteria to utilize:

0.5.1 Asset-based Sukuk: In an asset-based Sukuk, the issuer sells certain assets to Sukuk holders with a promise to buy these back in an agreed manner. Although an asset is used in the structure, it may not drive the return to Sukuk holders and the issuer's promise is not entirely dependent on the performance of the underlying asset. Thus, assessment of issuer's overall profile is critical to form a rating opinion. This type of Sukuk is also commonly referred to as "issuer-backed Sukuk".

0.5.2 Asset-backed Sukuk: This type of Sukuk provides separately identified ring-fenced assets to Sukuk holders. Here, commitments to Sukuk holders are met through cash flows emanating from these assets.

Distinguishing Framework for Asset-based and Asset-backed Structures

Sukuk Structure	Asset-based (Issuer-backed)	Asset-backed
Transaction	Assets are sold by issuer to the Sukuk holders with a promise to buy back	Identified assets are transferred to a separate entity that makes the sale to Sukuk holders and raises funds
Ownership of Asset	Beneficial ownership of asset with liquidation rights at par with other creditors	Legal ownership of assets with exclusive rights
Source of repayments	Issuer's cash flows	Cash flows from underlying assets
Asset location	Asset stays on issuer's balance sheet	Separate entity carries the asset
Credit Risk	Performance of issuer	Value and Performance of underlying asset s
Event of Default	Recourse to issuer and underlying security if it is explicitly earmarked in favour of Sukuk holders	No recourse to issuer
Recovery	Sukuk holders' rights are similar to unsecured creditors; subject to security structure	Clawback/liquidation of identified assets

1. Rating Asset-based (Issuer-backed) Sukuk

- Issuer Profile
- Notching
- Credit Enhancements

Rating Asset-based (Issuer-backed) Sukuk

1.1 Globally, asset-based Sukuk structure is most preferred owing to ease in structuring of such instruments and expertise available to structure and market these Sukuk. Around 90% of Sukuk issued globally are asset-based. Generally, high rated issuers can easily raise finances by issuing asset-based Sukuk.

1.2 The credit risk in an asset-based Sukuk terminates into the issuer of the Sukuk. Here, in case of default, Sukuk holders have recourse to the issuer and not the asset. Therefore, Sukuk holders would not have any preferential position and would stand along other unsecured creditors, in case of default. This means that, to establish credit quality, PACRA would evaluate issuer's credit profile to formulate a rating opinion. After forming an opinion on credit risk of the issuer, the proposed Sukuk is analyzed to assess the objective of raising funds, the tenor, pricing, and availability of cash flows from issuer's overall business to cover the committed repayments.

1.3 Issuer Profile: While forming an opinion on an issuer, PACRA evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply, while, for an independent power producer, IPP Rating Methodology would be used to arrive at entity rating of the issuer. Broadly, the rating criteria applied is as follows:

Qualitative Factors	
Qualitative risk profile is assessed by soliciting information from client and direct interaction with sponsors, management, and/or directors and conducting a visit to plant site and head offices.	
Profile	
Background	Evolution of the company since its inception
Operations	Range of products/services, diversity, scale of operations
Ownership	
Ownership Structure	Study of legal structure of entity and shareholding mix in order to disentangle the structure of ownership and identify the man of the last mile
Stability	Formal succession planning (in case of family owned concerns: clarity of role amongst family members)
Business Acumen	Sponsors' industry-specific working knowledge and strategic thinking capability
Financial Strength	Ability of sponsor to arrange funds or find alternate resources when needed, and willingness of sponsor to support the issuer measured by looking at shared brand name, size of investment versus other investments of sponsors
Governance	
Board Structure	Size of board, composition, degree of independence, level of delegation of board oversight to committees of the board.
Members' Profile	Qualification and experience of board members
Board Effectiveness	Number of board meetings, attendance and level of active participation
Transparency	Composition of audit committee, quality of internal and external auditors, and public disclosures
Management	
Organizational Structure	Complexity or simplicity of organizational structure relative to business needs, adequacy of staffing, cohesiveness amongst management team
Management Team	Qualification and relevant experience of management team, market reputation and integrity
Management Effectiveness	Type and frequency of information used by the senior management to assist decision making
Control Environment	Policies and procedures, risk management framework, technology

Quantitative Factors	
Quantitative risk profile is assessed by looking at economic conditions, industry dynamics, standalone performance relative to peers – through financial statements, projections, financial strategy and cash flow analysis. This is very much numbers driven.	
Business Risk	
Industry Dynamics	Macroeconomic analysis, business cycle, demand and supply dynamics of products, cost structure relative to other players, regulatory environment
Relative Position	Placement of entity in the related market in terms of market share, growth trend and competitiveness
Revenues	Stability and diversification of revenue (diversification from each dimension – product , customer , geographical), non-core income
Cost Structure	Conversion cost relative to peers, margins and profitability, sources of profitability – volume vs price
Sustainability	Future plans of the company, expected developments in industry and view on economic indicators
Financial Risk	
Working Capital	Working capital management – inventory, trade receivables, trade payables, financing of working capital, cushion against net trade assets, asset liability mismatch
Coverages	Sources of cash flows – core business, dividends, gain on sale of assets. Stability is also critical. Trend of cash flow growth and sustainability
Capital Structure	Leverage philosophy of management, reliance on external financing and level of financial flexibility

1.4 Notching: For any given Sukuk rating, notching is done using the entity rating of the issuer as a baseline (also called issuer rating). The Sukuk rating is notched either "higher" or "lower" compared to its corresponding issuer rating. The primary factors impacting notching are: i) Relative seniority of the Sukuk, compared to the issuer's other obligations, ii) Underlying collateral, and iii) Credit enhancements (if any). A summary of notching guidance is presented in the table below:

Instrument Type	Likely Notching Impact
Senior Unsecured Sukuk	0
Senior Secured Sukuk	+1
Subordinated Sukuk	-1, -2

1.4.1 Relative Seniority of the Sukuk: A senior unsecured Sukuk carries the same rating as its issuer. Meanwhile, notching for legally subordinated Sukuk is minus one for high-rated issuers. However, minus two notches may be applied in case of lower rated issuers where the Sukuk is deemed to be deeply subordinated (i.e. represents a small share of the issuer's total debt).

1.4.2 Collateral: Where a Sukuk is secured, the extent of notching is also influenced by the quality of the underlying collateral it is secured against, since this determines recovery prospects in case of default. PACRA looks at the following features of the collateral:

- Current valuation and associated volatility thereof; the more volatile the value of a security is deemed to be, the less favorable the notching impact
- Liquidity/marketability; the higher the likelihood of the security being monetized in a timely manner with minimal premium, the more favorable the notching impact
- Nature of charge

1.4.3 In certain cases, PACRA's ratings may differ from the notching guidance specified in the table above. For example, where an issuer maintains an unbalanced capital structure whereby the particular Sukuk comprises either a very significant or insignificant proportion of total debt, and/or where there is significant complexity in the legal structure of the terms of the Sukuk, among other considerations.

1.5 **Credit Enhancements**: The presence of certain structural features may enhance the rating of the Sukuk relative to its issuer or its issuer's other debt instruments. Two common forms of such features are third party guarantees and cash collection mechanism.

1.5.1 **Third Party Guarantees:** The debt instruments that carry third party guarantee to make good the amount obligated to the lenders by the issuer may provide additional support to its rating. In this case, in determining the rating of the instrument, key factors to assess are the financial profile of the guarantor (or its credit rating, where available) and the extent of coverage it provides to the instrument holders.

1.5.2 **Cash Collection Mechanism:** Few debt instruments are secured by a cash collection mechanism, whereby cash flows generated from a particular stream of revenue are used to fund the debt service reserve or fund. While arriving at its rating opinion, PACRA's assessment incorporates the issuer's operational viability to continue to serve its customers from whom the cash flows are expected to generate. In this case, PACRA attempts to assess the financial profile of these customers and the level of diversification in related customer base. Provision of any upfront liquid asset/cash collateral may also improve instrument's rating.

2. Rating Asset-backed Sukuk

Rating Asset-backed Sukuk

2.1 PACRA's Structured Finance Rating Methodology is utilized to assess or rate such type of Sukuk. In case of deficiency in cash flows, Sukuk holders retain complete recourse to underlying assets. However, they have no recourse beyond those assets to underlying issuer. Establishing the quality of expected cash flows and their sufficiency to meet commitments is critical. Quality primarily focuses on likely changes in cash flow pattern in response to entity specific, industry wide, or economic changes. The rating would be dependent on quantum and sustainability of coverages against the commitments during the life of the Sukuk. PACRA also considers potential of recovery from underlying assets in case of default.

Asset-backed Sukuk – Rating Factors	
Asset risk - Quality of Expected Cash flows	▪ Underlying Assets are unique and so are the cash flow ; this requires analysis of ability of assets to generate cash flows ▪ Likely changes in cash flow pattern in response to economic, industry, and entity specific factors ▪ Data heavy analytical approach; analysis of past trends and future projections of cash flows from securitized assets
Payment risk - Sufficiency of Expected Cash flows	▪ Adequacy or timing of cashflows vis-à-vis payment terms

	▪ Quantum of cash flows to meet commitments – full cash flows or carved out cash flows ▪ Evaluation of payment structure – right and priority of investors to receive cash flow ▪ Availability of credit enhancements
Recovery Risk - Potential of Recovery	▪ Legal structure for sale and realization of Sukuk assets ▪ Loss in case of default

2.2 Asset-backed Sukuk are preferred by issuers who intend to isolate their own financial strength from new financing. This facilitates attracting investors, particularly for issuers who are relatively weak but have some established asset (with respective cash flows) that can be carved out.

3. Surveillance

Surveillance

3.1 Once a Sukuk is issued, PACRA provides a valuable tool for investors by monitoring and reporting on its performance. In this regard, relationship with trustee of Sukuk is established. Each profit and principal payment is confirmed from the trustee. The surveillance frequency depends on payment terms and frequency of payments. However, a formal review is undertaken once in every six months.

Annexure: Islamic Modes of Financing

Each asset-based or asset-backed Sukuk can follow different modes of Islamic financing. Since 2001, Morabaha based Sukuk dominate the total Sukuk issues around the globe. Brief explanation of each mode of financing follows as:

Mode	Objectives	Details
Musharaka	Partnership in business	A relationship for sharing of profits and losses in the business. Islamic bank provides funds, which are mixed with the funds of the business enterprise. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.
Mudarabah	Partnership in business	One party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.
Murabaha	Working Capital Financing Inventory	The client (obligor) requests the bank (financer) to purchase certain goods for it. The bank then sells goods to the client on credit. The bank does that for a definite profit over the cost, which is stipulated in advance.
Waqala	Working Capital Financing Receivable	An arrangement whereby one party entrusts another party to act on its behalf. It is akin to an agency arrangement. A principal (the financer) appoints an agent/wakeel (the obligor) to invest funds provided by the principal into a pool of investments or assets and the wakeel lends it expertise and manages those investments on behalf of the principal for a particular duration, in order to generate an agreed upon profit return.
Salam	Short-term financing	On spot buying of underlying assets and sale of asset to finance at a later date. Obligor purchases the asset at a later date.
Istisna	Project financing	Advance payment of capital cost of the project by financier. Obligor reimburses the capital cost plus profit on project.
Ijarah	Lease financing	Purchase of tangible assets at a pre-agreed price with permission to use the asset against rentals. Obligor pays fixed periodic rentals.

Credit Rating

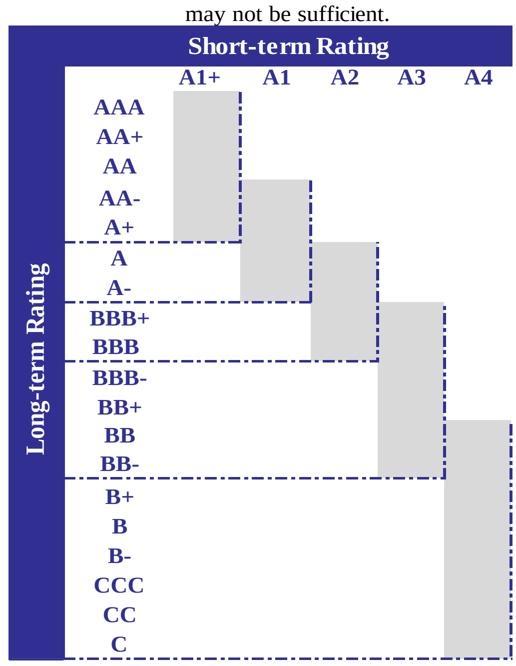
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating