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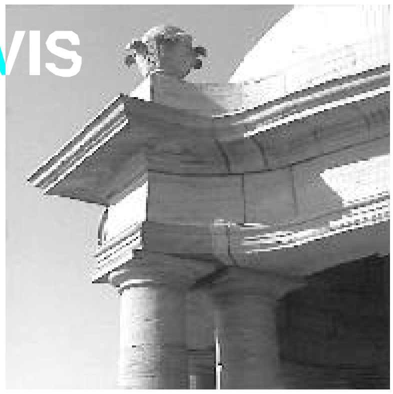

MODARABA RATING SCALE

Special Report

The modaraba sector is the largest sector in Pakistan's financial market in terms of number of entities, with 45 modarabas listed on the Karachi Stock Exchange as against 15 commercial banks, 29 leasing companies and 16 investment banks. The formation of this sector in the early eighties following the passage of enabling laws represented the first organised effort in Pakistan to institutionalize Islamic modes of business. This paper concentrates on the need for change of the rating scale used by JCR-VIS for rating modarbas and is a continuation of JCR-VIS's policy of bringing complete transparency in its working and keeping investors appraised of new developments.

The rating scale currently in use for modarabas in Pakistan is different from the credit rating scale used for all other institutions where internationally recognised rating symbols are used. However, since Islamic modes of financing are now beginning to enter the mainstream (e.g. the launch of the first Islamic commercial bank and the issue of the first musharika based Term Finance Certificate), the approach of distinguishing ratings of Islamic institutions and instruments from other ratings needs to be reconsidered.

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Background

JCR-VIS had initially started by rating modarabas on its conventional rating scale, assigning both medium to long-term and short-term ratings. This was consistent with the approach adopted for all other entity ratings. On the other hand, the other rating agency in the country used a separate modaraba scale from inception. JCR-VIS reviewed and changed its policy in this regard following the issuance of BPRD Circular No. 05 dated February 15, 2000 by the State Bank of Pakistan (SBP). While taking the commendable step of relaxing the condition for banks to obtain prior written clearance from the SBP before providing financing to modarabas, this circular made the relaxation dependent on a minimum credit rating of B-3 for the concerned modaraba. This symbol was part of the seperate modaraba scale and therefore, in order to avoid confusion, JCR-VIS also adopted this scale.

Subsequent Developments

There have been significant developments in Pakistan with respect to Islamic finance in the period ensuing the change of rating scale for modarabas by JCR-VIS. Firstly, in view of the latest decision of the Supreme Court of Pakistan on the riba issue, it would be safe to assume that both the conventional and the Islamic systems of finance will work in parallel in Pakistan for the time being.

This situation is not unique to Pakistan. Malaysia has been operating such a parallel system for many years now. This has resulted in a great deal of research and innovation in the area of Islamic finance as institutions run in conformity with Shariah principles seek to compete with the more established and accepted modes of financing. The success of the Malaysian model can be gauged by the fact that the use of Shariah compliant instruments is one of the main factors behind Malaysia becoming the second largest bond market for project finance in the world. The important feature of the parallel system is that it allows freedom of choice. Therefore, institutions working on a 'riba-free' basis will have to develop a range of products and services that would practically prove that the Islamic system can be competitive with the conventional financial system.

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The efforts towards establishing a viable Islamic financial sector are slowly gaining momentum. The granting of the first Islamic commercial banking license to Meezan Bank Limited (formerly Al-Meezan Investment Bank Limited) represents a major milestone. The bank is reporting a great deal of interest from depositors and borrowers alike. The recent issue by Sitara Chemicals Limited of the first listed musharika-based Term Finance Certificates and the overwhelming investor response to the issue reflects the depth of the market for Shariah compliant sources of investment. The interesting thing to note about both the above-mentioned companies is that their respective entity and instrument ratings are on the conventional rating scale. This renewed interest in Islamic finace augurs well for the modaraba sector because it is, in our opinion, the ideal platform from which the development of the Islamic financial sector can be fostered, as the legal and organisational infrastructure is already in place.

JCR-VIS, as more fully explained below, is of the firm belief that Shariah compliant non-equity funding represent obligations. Hence, the persons providing the funding must have some sort of benchmark for measuring the risk that they are undertaking while lending to institutions raising funds through Islamic modes of financing.

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Shortcomings of existing scale

The existing rating scale for modarabas has several shortcomings. The foremost of these is that it does not serve the primary purpose of credit rating, which is to benchmark the degree of risk across various companies and sectors of the economy. By using a separate scale for one sector of the economy i.e. the modaraba sector, we have excluded the possibility of comparing the degree of risk entailed in providing funds to a modaraba against that of institutions in other sectors.

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The second point to consider is that by treating modarabas separately in this respect, the rating agencies seem to be indicating that modarabas are fundamentally different entities in terms of their activities. As modarabas are permitted to engage in all sorts of financing, trading and manufacturing activities allowed to other companies/institutions, this is an inaccurate impression. The only condition imposed on the activities of modarabas is that they should be Shariah compliant. The same holds true for fund raising activities of the modarabas. Therefore, the only real differential between modarabas and other organisations is the ownership structure of the modarabas. In view of the two examples given above (i.e. Meezan Bank Limited and Sitara Chemicals Limited), conformance to Shariah principles can no longer be considered a peculiar characteristic of the modaraba sector and hence the justification to rate modarabas on a separate scale is further weakened.

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The absence of a short-term rating in the current modaraba scale is also a cause for some concern as the differing rating horizons for medium to long-term ratings and short-term ratings means that there is a marked difference in emphasis on the rating factors involved. Therefore, a modaraba presently looking to acquire short-term funding cannot rely on its assigned rating.

Further, as the trend of globalisation continues to gain strength and Pakistan's economy develops, there will be new opportunities for cross-border transactions and investments. This process would be greatly aided by the presence of universally understood rating symbols. The confusion inherent in the existing modaraba scale can be judged by the fact that when the symbol B-3, which is the minimum investment grade on the current modaraba scale, is used by a leading global rating agency, it denotes a rating which is substantially below investment grade.

The last but not least criticism of the modaraba scale is the high degree of compression in the investment grade ratings relative to the conventional scale with there only being 6 notches for investment grade ratings in the modaraba scale as compared to 10 in the conventional scale. Consequently, even within the modaraba sector, the existing scale would highlight only very significant risk variations.

Can the same scale be used?

To understand whether modarabas, or for that matter any other institution or instrument based on Shariah principles, can be rated on the conventional scale, it would be necessary to study the definitions used by JCR-VIS for both medium to long-term and short-term conventional ratings (please see attached scale).

From these definitions it is apparent that the determination of the appropriateness of the conventional rating scale for entities and instruments working in conformance with Shariah principles should be based on the interpretation of two key words i.e. risk and obligation.

Risk is defined as the possibility of a loss in an investment, or in a financial transaction, depending on the type of the risk. Hence, any financing transaction, be it conventional or Shariah based, entails a certain risk. The risk in a conventional transaction is that a fixed sum (principal and/or mark-up) will not be paid on the due date. Even in the case of floating rate instruments, the coupon rate is fixed a specified period before the due date. Some Islamic forms of financing e,g. Morabaha and Ijarah also carry a similar risk. However, in case of instruments based on profit and loss sharing (e.g. Musharika) calculation of the sum due is based on the operating results of the investee upto the due date. Therefore, in such cases the investor assumes the risk of not receiving a certain amount of profit, which he reasonably expected based on the history and/or projections of the investee and more importantly the risk of capital loss. Since the job of the rating agency is to benchmark the degree of risk, the difference in the nature of risk should not be a hindrance in carrying out the ratings on the same scale. For example a conventional instrument rated BBB- will carry the same probability of full timely repayment as of loss of profit/capital for an equally rated Islamic instrument. It would be pertinent to note here that, in line with international practice, JCR-VIS is using the conventional rating scale to also carry out Bank Finance Ratings, where risk is defined as the failure of ultimate recovery of the present value of the scheduled repayment.

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An obligation very simply means a duty. This duty when referred to in the context of a financial transaction in most cases arises out of a contract that defines the rights and duties of the parties to the contract. In the case of the investee, one of the duties (or obligations) is to make payments in accordance with the terms of the contract. The definition of obligation does not necessarily extend itself to include the fact that the exact value of the obligation should be known at any time before the due date. A potential conventional finance scenario would be where the coupon rate, in the case of a floating rate debt, is determined on the basis of a base rate prevailing on the coupon date. The remaining terminology used in JCR-VIS's definitions is very clear and can apply equally to any kind of entity or instrument.

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In view of the foregoing discussion, JCR-VIS considers it in the best interest of the modaraba sector that credit ratings of modarabas be expressed on the same scale used for all other credit ratings.

Rating Scale & Definitions

Medium to Long-term

AAA: Highest credit quality. The risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA- High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A- Good credit quality. Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB- Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB- Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B- Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC A high default risk.

C A very high default risk.

D Defaulted obligations.

Short-term

A-1+ Highest certainty of timely payment. Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

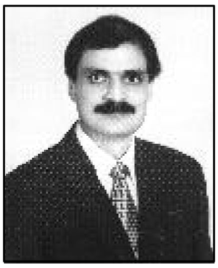
A-1 High certainty of timely payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2 Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3 Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B Speculative investment characteristics. Liquidity may not be sufficient to ensure timely payment of obligations.

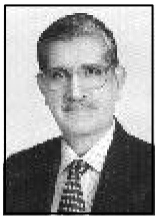
C Capacity for timely payment of obligations is doubtful.



Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copy righted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.



Jamal Abbas Zaidi
Executive Vice Presidentt

Jamal Abbas Zaidi has more than three decades of rich experience in finance and general management, at local and international level. Prior to joining JCR-VIS, he was CEO of a leasing modaraba and SEVP of the then largest leasing company having IFC and ADB equity. Internationally, he worked for World Bank at a multi-million dollar project in Nigeria. Mr. Zaidi has held key positions in the industrial and financial sector and has contributed many papers in international and local conferences and workshops. He is a member of rating committee of JCR-VIS.

He is a fellow member of the Institute of Cost and Management Accountants of Pakistan.

Saad Ahmed Madani
Vice Presidentt

Saad Ahmed Madani leads ratings of Industry, NBFI's and Islamic Finance at JCR-VIS. He has also remained involved in ratings of commercial banks and leasing companies.

He is a Chartered Accountant (CA) from the Institute of Chartered Accountants of Pakistan.

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